

WILLKIE FARR & GALLAGHER LLP

1875 K Street, NW
Washington, DC 20006

Tel: 202 303 1000
Fax: 202 303 2000

August 8, 2006

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
Room TW-325
445 12th Street, S.W.
Washington D.C. 20554

Re: In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of
Transfer Of Control, WC Docket No. 06-74
Response to Applicants' Joint Opposition to Petitions to Deny

Dear Ms. Dortch:

Time Warner Telecom, Inc ("TWTC") hereby submits its response to the Joint Opposition of AT&T Inc. and BellSouth Corporation to Petitions to Deny and Reply to Comments.¹ Specifically, this response focuses on (1) the Applicants' continuing market power over the facilities required to serve enterprise customers and (2) in light of this market power, the public interest harms that will result from the merger because of the increase in the size of the Applicants' footprint and regulators' diminished ability to monitor and regulate RBOC behavior due to the loss of Bellsouth as a "benchmarking firm".

In addition, we have attached a declaration authored by Graham Taylor² of TWTC responding to allegations made by Parly Casto³ of AT&T with respect to AT&T's refusal to provide advanced services to TWTC on reasonable terms and conditions. Also attached is a paper by Economists Stanley M. Besen and Bridger Mitchell of CRAI⁴ further explaining the harms that will result from the expanded footprint of the merged company and the loss of a benchmarking firm.

A confidential version of this response has also been filed with the Secretary.

¹ See Joint Opposition of AT&T Inc. and BellSouth Corp. to Petitions to Deny and Reply to Comments, WC Dkt. No. 06-74 (filed June 20, 2006) ("*Opposition*").

² See Reply Declaration of Graham Taylor, attached hereto as Attachment A.

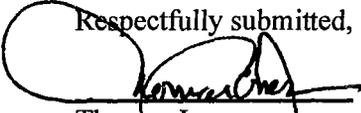
³ See Reply Declaration of Parley C. Casto, attached to *Opposition*.

⁴ See Joint Declaration of Stanley M. Besen and Bridger M. Mitchell, CRA International, attached hereto as Attachment B (July 19, 2006).

REDACTED-FOR PUBLIC INSPECTION

Please let us know if you have any questions with respect to this submission.

Respectfully submitted,



Thomas Jones
Jonathan Lechter

WILLKIE FARR & GALLAGHER LLP

1875 K Street, N.W.

Washington, D.C. 20006

(202) 303-1000

ATTORNEYS FOR TIME WARNER TELECOM INC.

Enclosures

cc: Donald K. Stockdale Jr. (w. encl.)
William Dever (w. encl.)
Nicholas Alexander (w. encl.)
Gary Remondino (w. encl.)

REDACTED - FOR PUBLIC INSPECTION

RESPONSE OF TIME WARNER TELECOM, INC.

TO AT&T INC. AND BELLSOUTH CORPORATION JOINT OPPOSITION

TO PETITIONS TO DENY AND REPLY TO COMMENTS

Time Warner Telecom, Inc. ("TWTC") hereby files its response to arguments made by the Applicants in their Joint Opposition to Petitions to Deny and Reply to Comments.¹

1. Introduction and Summary

TWTC explained in its *Petition to Deny*² that AT&T and BellSouth continue to control an overwhelming percentage of the end-user connections needed to serve business customers, and the merger of these two carriers will increase the merged entity's ability and incentive to use its market power over these inputs to raise rivals' costs. The FCC found in its prior RBOC merger orders that the expansion of an RBOC's footprint through merger allows the merged firm to appropriate a larger share of the benefits from raising rivals' costs. As explained in the attached declaration by Dr. Stanley M. Besen and Dr. Bridger M. Mitchell,³ this is as true of the present merger as it was in past mergers. In this case, the national share of AT&T's switched access lines will increase from 28.62 to 40.29 percent and AT&T will add hundreds of thousands of high capacity loops in the BellSouth region, substantially increasing the size of the merged

¹ See Joint Opposition of AT&T Inc. and BellSouth Corp. to Petitions to Deny and Reply to Comments, WC Dkt. No. 06-74 (filed June 20, 2006) ("*Opposition*").

² See *Petition to Deny* of Time Warner Telecom, WC Dkt. No. 06-74 (filed June 5, 2006) ("*Petition*").

³ See Joint Declaration of Stanley M. Besen and Bridger M. Mitchell, CRA International, attached hereto as Attachment B (July 19, 2006) ("*Besen/Mitchell Decl.*").

REDACTED - FOR PUBLIC INSPECTION

company's footprint.⁴ Because the benefits of exclusionary conduct increase with a larger footprint, the merged company's incentive to engage in this conduct also increases. Moreover, there is no question that AT&T has acted on those incentives in the past. TWTC filed as an attachment to its *Petition to Deny* a declaration by Graham Taylor demonstrating that AT&T (already the RBOC with the largest footprint) has overpriced, denied, delayed and degraded TWTC's access to inputs that TWTC needs to provide advanced services such as finished Ethernet services and class of service ("CoS") and quality of service ("QoS") for IP VPN traffic that traverses two carriers' networks.⁵ Again, the merger would make this problem much worse.

[proprietary begin]

[proprietary end] Indeed, as Drs. Besen and Mitchell explain, the merged firm will have the incentive to act in a more discriminatory fashion than even AT&T does currently.

As TWTC explained in its *Petition*, changes in demand patterns for Ethernet and IP VPN will make the effects of the merger even more harmful than would otherwise be the case. As TWTC further explained, customers with locations in both the BellSouth and AT&T ILEC regions already account for **[proprietary begin]**

[proprietary end] in those two regions. *See Petition* at 5. Customers increasingly demand that TWTC serve all, not just a subset, of the customers' locations so that their IP networks can be

⁴ *See* RBOC Market Share Chart, *Petition* App. B.

⁵ *See* Declaration of Graham Taylor on Behalf of Time Warner Telecom, Inc., *Petition* App. A ("Taylor Decl.").

better managed and integrated. In many cases in the past, TWTC only served those locations that it could connect to with its own network. In the future, as TWTC is increasingly required to provide Ethernet and IP VPN services to all of a customer's locations, TWTC will have no choice but to rely increasingly on the ILECs' local transmission facilities. *See id.* at 48.

Moreover, because few or no price and non-price regulations apply to ILEC Ethernet or IP VPN service, the Applicants' ability to discriminate without detection will increase.

The loss of BellSouth as a benchmark against which to judge the conduct of other large ILECs, including AT&T, will also substantially reduce the FCC's ability to fashion regulations governing the inputs required by TWTC and other CLECs to provide IP-based services. Given that Qwest is far smaller than either Verizon or a merged AT&T/BellSouth and qualitatively different than the other RBOCs in many ways, it is likely that only two RBOCs will remain against which to benchmark post-merger. *See id.* at 62-63. As Drs. Besen and Mitchell explain, this will likely eliminate the utility of benchmarking completely. *See Besen/Mitchell Decl.* ¶ 102. This is a very serious and harmful consequence of the merger. State regulators and the FCC have continued to rely on RBOC-to-RBOC benchmarking since the last RBOC mergers (*see Petition* at 53-56) and the increasing deployment of advanced services that the Commission has little experience regulating will significantly increase the need for benchmarking in the future.

Repeating arguments made in their public interest statement, the Applicants make two general arguments in their opposition as to why the FCC should not be concerned about the increased footprint of the combined entity or the loss of a benchmarking firm. *First*, they allege that they no longer have market power over the transmission facilities and other inputs needed to serve the enterprise market and therefore do not have the ability to discriminate against

competitors. *Second*, they argue that whatever harms result from an increased footprint and the loss of a benchmarking firm are remedied by existing regulations, and that any additional regulations can be fashioned through “parity” comparisons. These claims have no merit.

2. The Applicants Have Substantial And Persisting Market Power Derived From Their Control Over Bottleneck Transmission Facilities Needed To Serve Business Customers

The Applicants argue that the Commission need not be concerned about the enormous increase in the merged company’s footprint because “RBOCs no longer have monopoly control over the inputs that competing carriers need.” *Opposition* at 91. The overwhelming market evidence demonstrates that this assertion is simply untrue.

Retail Competition. The Applicants argue that “the provision of high-capacity local services is intensely competitive.” *Id.* at 92. They allege that because “foreign-based companies, competitive LECs, cable companies, systems integrators, equipment vendors and value-added resellers” are competing in the enterprise market, the RBOCs no longer control bottleneck facilities needed to provide enterprise services. *See id.* at 93. This is a non-sequitur. All of these classes of companies (and by definition resellers and systems integrators), must rely completely or almost completely upon RBOC last mile facilities to provide enterprise class services to businesses.

The Applicants also assert that recent press releases regarding the geographic expansion of CLEC service offerings is evidence that CLECs are no longer reliant on ILEC facilities. As they did in the *Special Access Pricing NPRM* and *Triennial Review Remand* proceeding, the Applicants attempt to equate CLEC retail service offerings with the deployment of facilities used to provide these services. But as the Commission well knows, offering service at retail is entirely different from deploying the underlying facilities needed to provide retail service. For

REDACTED - FOR PUBLIC INSPECTION

example, while Cbeyond may have “boasted of capturing its 20,000th small/medium business customer” and Pac-West is “executing on a planned expansion” (*see id.* at 40-41), Cbeyond does not deploy *any* of its own loop facilities⁶ and “Pac-West serves all customers via facilities obtained from other carriers, with much of that being obtained from the ILECs.”⁷ Moreover, while Xspedius may have “revealed growth plans” throughout the South (*id.* at 40), (1) most of Xspedius “on-net” locations actually serve IXC POPs, LEC wire centers and carrier hotels, not end user locations;⁸ (2) Xspedius cannot build a fiber “unless customer demand [] exceeds at least 3 DS3s of capacity;” (*Falvey Decl.* ¶ 25) and (3) and “it almost never is economic for Xspedius to construct its own wireline DS-1 loop facilities” (*id.* ¶ 26).

The Applicants imply that because CLECs can and do in some cases deploy OCn-level services, the Commission has held that CLECs can provide DSn-level services to any location through channelization. *Opposition* at 93. This is not what the FCC held. Rather, the Commission determined that channelization is possible, but only at that limited number of locations at which customers already demand very high capacity connections.⁹

⁶ Cbeyond explains that all of its customers are served by DS1 loops provided by ILECs because it is never economically rational for Cbeyond to deploy DS1 facilities. *See* Declaration of Richard Baatelan on behalf of Cbeyond, attached to Comments of ALTS, WC Dkt. Nos. 04-313 *et al.*, App. C ¶ 5 (Oct. 4, 2004).

⁷ *See Ex Parte* Letter of Richard M. Rindler, Counsel, Pac-West, to Marlene H. Dortch, Secretary, FCC, CC Dkt. Nos. 01-338 *et al.*, at 2 (Sept. 7, 2004).

⁸ *See* Declaration of James C. Falvey, on behalf of Xspedius Communications, attached to Comments of Loop and Transport CLEC Coalition, WC Dkt. Nos. 04-313 *et al.*, ¶ 20 (Oct. 4, 2006) (“*Falvey Decl.*”).

⁹ *See Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Order on Remand, 20 FCC Rcd 2533, ¶ 154 (2005) (“*TRRO*”). (“[C]arriers can sometimes economically serve lower-capacity customers (e.g., customers at the DS1 capacity level) in multi-tenant buildings because the incremental costs of providing channelized capacity over a higher-capacity fiber loops are minimal when one

Competitors' Deployment of Local Transmission Facilities. The Applicants argue that CLEC deployment of thousands of miles of local fiber and the connection of thousands of buildings to these local fiber networks proves that, "there are no significant barriers to the deployment of local fiber networks and thus the provision of Type I special access services in BellSouth's region."¹⁰ But subsequently in their own opposition, the Applicants observe that fiber *transport* networks are a necessary, but not sufficient, condition for CLECs to serve end-user customers. Elsewhere in their opposition, they state that, "As the DOJ explained, 'two of the most important factors in determining whether entry is likely in a given building are the proximity of competitive fiber to that building and capacity required by the building.' 'The closer a building is to a competitor's fiber, the less it is likely to cost that competitor to install additional fiber to reach that building' and the 'larger the demand for capacity in a building, the greater the expected revenues.'"¹¹ The FCC came to the same conclusion in the *TRO* and *TRRO*.¹² Applying this analysis, the FCC has held that CLECs cannot deploy DS1 and DS3 *loop* facilities in most instances. See *TRRO* ¶ 166. In the *TRRO*, the FCC specifically rejected as non-probative ILEC supplied maps showing dozens of CLEC fiber *transport* networks and

or more other customers in a building are already served by competitive fiber of sufficient capacity, or the likelihood of capturing customers at higher capacity justifies deployment of facilities that can be channelized to the DS1 level.") (footnote omitted).

¹⁰ Reply Declaration of Dennis W. Carlton and Hal S. Sider, attached to *Opposition*, ¶ 24 ("Carlton/Sider Decl.").

¹¹ *Opposition* at 20 & n.69 (citing DOJ Response to Public Comments at 23 n.40; 24).

¹² See *TRRO* ¶ 150; *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, Report and Order, 18 FCC Rcd 16978, ¶ 206 (2003), *subsequent history omitted* ("TRO").

REDACTED - FOR PUBLIC INSPECTION

thousands of miles of CLEC deployed fiber rings and CLEC lit buildings (usually relying on ILEC loops) as evidence of the ability of CLECs to deploy their own *loop* facilities on a widespread basis.¹³ The Applicants' reliance on CLEC fiber mileage and number of buildings served (regardless of the owner of the loop) in this proceeding is unpersuasive for the same reasons.

The available market evidence demonstrates that ILECs in general and the Applicants in particular control the vast majority of loop transmission facilities needed to serve business customers. Less than two years ago, the RBOCs stated in their "UNE Fact Report" that competitors served 31,669 buildings¹⁴ with their own fiber loops as compared to the hundreds of thousands or millions of buildings served by ILEC fiber.¹⁵ More recently, Verizon claimed that CLECs have deployed loops serving "31,467+" buildings nationwide.¹⁶ Clearly, the overall competitive landscape has not changed appreciably, if at all, over the last few years. Verizon

¹³ *TRRO* ¶ 187 ("The maps provided by the incumbent LECs do not specify the capacity of service demanded in particular locations along the competitive routes identified; if those locations require capacity only at multiple DS3 or higher capacities, and are providing revenues commensurate with those capacities, then the presence of competitive routes is not relevant to the question whether it is economic to deploy to serve customers at the DS1, or even the single DS3, capacity level. Similarly, as described above, the costs of deployment will depend in part on the length of the lateral that must be constructed between the building being served and the splice point on the fiber ring. The incumbent LECs' maps do not indicate the placement of splice points, rendering evaluation of such costs impossible.").

¹⁴ See *UNE Fact Report 2004*, Prepared for and Submitted by BellSouth, SBC, Qwest, and Verizon, Dkt. Nos. 04-313 *et al.*, at III-4 (Oct. 4, 2004).

¹⁵ See *TRRO* ¶ 157 (stating that the record indicates that there are between 700,000 and 3 million commercial buildings in the nation).

¹⁶ See Verizon Comments, WC Dkt. No. 05-25, Attach. D, Declaration of Quintin Lew, at App. B, (June 13, 2005).

REDACTED - FOR PUBLIC INSPECTION

indicates that back in 1996 there were fully 24,000 buildings “served directly by CLEC fiber.”¹⁷ In other words, in nearly 10 years, CLECs have added connections to only approximately 8,000 buildings. This only underscores the difficulty of loop deployment and the ILECs’ continuing dominance of the special access marketplace.

The Applicants make much of the fact that TWTC increased the number of buildings served by its own fiber by 17 percent last year. *See Opposition* at 23. It is true that TWTC now serves 6,185 buildings over its own fiber facilities. Yet, TWTC remains heavily reliant on ILEC loop facilities. While TWTC serves 6,185 buildings on-net, it provides service to another 16,865 buildings via leased (usually ILEC) special access loops.¹⁸ Therefore TWTC serves only 26.8 percent of its customer locations using its own facilities, while it must rely on other carriers (almost exclusively the ILECs) 73.2 percent of the time.

By any measure, the market for local transmission facilities is overwhelmingly dominated by the ILECs (and of course the Applicants in their regions). If, as the ILECs asserted, CLECs in 2005 served 32,000 of the 700,000 to 3 million locations that demand enterprise level services, CLECs only possessed a 1.1 to 4.6 percent of the high capacity transmission loop facilities needed to provide TDM and packetized services to enterprises. Assuming that CLECs as a whole, like TWTC, were able to increase the number of buildings that they served by 17 percent (and there is no indication that this is the case, especially with the elimination of an independent AT&T and MCI), CLECs would now serve 37,440 buildings or between 5.3 and 1.2 percent of

¹⁷ *See* Verizon Comments, WC Dkt. No. 05-25, Attach. C, Declaration of William E. Taylor, at Table 10, (June 13, 2005).

¹⁸ *See* Time Warner Telecom, Inc., SEC Form 10-Q Quarterly Report for the Period Ended Mar. 31, 2006, at 24 (filed May 10, 2006).

buildings nationwide. In any market characterized by high entry barriers and in which one company controls 95 percent of that market, that company must be considered to be dominant and able to exercise its market power.

TWTC does not dispute the fact that non-ILEC special access wholesalers exist (*see id.* at 98). In fact, TWTC itself offers special access at wholesale. But neither TWTC nor other non-ILEC wholesalers can deploy loop facilities to most buildings. Indeed, as Mr. Taylor explains, TWTC has purchased or is in the process of purchasing access to non-ILEC Ethernet loops to

[proprietary begin] [proprietary end]¹⁹ These [proprietary begin]

[proprietary end] represent less than [proprietary begin]

[proprietary end] of the locations to which TWTC currently provides Ethernet service at retail.²⁰ Therefore, TWTC must rely almost completely on the ILECs for last mile facilities to connect to locations for which TWTC cannot deploy its own loops. Moreover, other competitors report the same experience. Sprint/Nextel and T-Mobile state that they must rely on the ILECs for the fiber connection between their wireless towers and mobile switching centers 99 percent

¹⁹ See Reply Declaration of Graham Taylor, attached hereto as attachment A, ¶ 7 (“*Taylor Reply Decl.*”).

²⁰ As Mr. Taylor explains, [proprietary begin]

[proprietary end] *See id.*

and 94 percent of the time respectively.²¹ Numerous carriers have made similar statements regarding their dependence on ILEC facilities in the past and in this proceeding.²²

Obviously desperate to find examples of competitors deploying local transmission facilities, the Applicants tout TWTC's expansion of its Atlanta fiber network to demonstrate that any competitor can build local transmission facilities to any location. *See Opposition* at 22. If anything, however, TWTC's experience in Atlanta illustrates the ILECs' enduring power in the provision of local transmission facilities. Even after its network expansion, TWTC will remain reliant on BellSouth's loop facilities to provide "communications solutions to more than 6,000 additional businesses located in the Atlanta area."²³ Indeed, the same press release cited by the Applicants states that TWTC's network only "passes 350 buildings," (*see id.* & n.79)

[proprietary begin]

[proprietary end] But a [proprietary begin]

[proprietary end] is not actually served by TWTC loop facilities; [proprietary begin]

[proprietary end] are lit with TWTC fiber. To serve [proprietary begin]

[proprietary end] would require a substantial capital investment and,

²¹ *See* Sprint/Nextel Comments, WC Dkt. No. 06-74, at 9 (June 5, 2006); T-Mobile USA Response, WC Dkt. No. 06-74, at 5 (June 20, 2006).

²² *See, e.g.,* Paetec Comments, WC Dkt. No. 06-74, at ii (June 4, 2006) (stating that Paetec relies on ILEC special access for 95 percent of its last-mile connections to end-users); CompTel Petition to Deny, WC Dkt. No. 06-74, at 9 (June 5, 2006) (stating that "[w]ireless carriers are major consumers of ILEC special access services, because they have no choice") (*citing* AT&T Wireless Services Comments, RM-10593, at 2-3 (Dec. 2, 2002)); *id.* at 11 (stating that "even the competitive carriers with the largest networks must buy over 90% of their total special access circuits from the incumbents").

²³ *Opposition* at 22 & n.79 (*citing* Time Warner Telecom, Inc. Press Release, *Time Warner Telecom Extends Atlantic Fiber Network* (Jan. 20, 2006)).

REDACTED - FOR PUBLIC INSPECTION

in many cases, depending upon the demand and distance to the building, would not be economically rational.

The available evidence indicates that the market for broadband transmission facilities serving enterprises is even more concentrated in BellSouth's territory than the nation as a whole. As the Applicants admit, there are 219,000 commercial buildings demanding enterprise class services in BellSouth's territory. *See Carlton/Sider Decl.* ¶ 22. Yet, in the *Triennial Review Remand* proceeding, BellSouth stated that CLEC fiber loops serve only approximately 2,200 buildings in all of BellSouth's service area or 1 percent of the market.²⁴ Assuming that competitors have increased the number of buildings served by CLEC fiber by 17 percent to 2574 buildings since then (an extremely aggressive assumption), competitors would only retain a 1.2 percent market share in BellSouth's region. Considering this minuscule CLEC market-share of wireline transmission facilities, it is hard to see how the Applicants could argue that BellSouth does not maintain market power over these bottleneck inputs needed to serve the enterprise market in its region.

The Applicants attempt to argue, as they did in their public interest statement, that "cable companies. . . have significant business offerings." *Opposition* at 36. As TWTC explained in its *Petition*, however, the FCC has repeatedly found that *cable modem service* does not provide the level of service quality that most businesses require. *See Petition* at 35. To the extent that cable

²⁴ *See Ex Parte* presentation of BellSouth, attached to Letter of Glenn T. Reynolds, Vice President, Federal Regulatory, BellSouth, to Marlene H. Dortch, Secretary, FCC, CC Dkt. No. 01-338, at 4 (Aug. 18, 2004) ("In BellSouth's region: more than 2,200 buildings are served by non-ILEC fiber.").

companies serve enterprise customers, they do so largely using fiber optic facilities,²⁵ not hybrid fiber coax facilities, and therefore face the same barriers as other CLECs.²⁶ It is no doubt true that, as the Applicants argue, some businesses purchase some cable modem service for some uses. However, the FCC found that this fact does not show that cable modem service is a replacement for wireline loops for most business applications. *See TRRO* n.511. With respect to wireless services, the RBOCs themselves, despite having held licenses for WCS and BRS spectrum for many years, are only now rolling out wireless broadband services in extremely limited circumstances where there may be no other viable options (such as rural and disaster-stricken areas). *See Opposition* at 73-74. Clearly, even the Applicants do not believe that these services can replace the ILECs wireline facilities to serve enterprise customers.

Treatment of Special Access In Past Merger Orders. The Applicants argue that in earlier RBOC mergers, the FCC did not focus on merger-specific effects on special access services and therefore there is no need for the FCC to be concerned in this instance. *See id.* at 92. But the Commission focused in the past on ensuring the availability of UNEs and not special access simply because it considered UNEs fully sufficient inputs for the advanced and other service offerings being provided at the time.²⁷ Today, UNEs are not generally available for

²⁵ *See Opposition* at 37 (“In April 2006, Charter Communications announced the ‘deployment and implementation of an *optical* solution...’”) (emphasis added).

²⁶ *See TRRO* nn.511, 514.

²⁷ *See e.g., In re Applications of Ameritech Corp. and SBC Comm. Inc. for Consent to Transfer Control of Corporations Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95 and 101 of the Commission’s Rules*, Memorandum Opinion and Order, 14 FCC Rcd 14712, ¶ 370 (1999), *subsequent history omitted* (discussing condition to prevent RBOC discrimination with respect to the use of UNEs for “interim line sharing”) (“*SBC/Ameritech Order*”); *id.* ¶ 372 (discussing condition mandating discount for UNE loops used for advanced services until merged company can develop an advanced services OSS system).

REDACTED - FOR PUBLIC INSPECTION

purposes of providing Ethernet and other IP services. In the absence of UNEs and non-ILEC sources of supply, competitors have no choice but to rely on special access as the means of purchasing local transmission facilities needed to provide Ethernet and other IP-based services. Moreover, in light of the ILECs' resistance to allowing competitors' access even to the TDM UNEs to which they are entitled (*see TRRO* ¶ 64) (and for other reasons as well), CLECs have increasingly relied on special access for DS1 and DS3 loops and transport since the time of the last RBOC mergers. Indeed, the ILECs, including SBC, pointed to the CLECs' heavy reliance on special access facilities in the Triennial Review Remand proceeding in an attempt to show that CLECs no longer require access to UNEs.²⁸

The Applicants attempt to waive away TWTC's assertions regarding the Applicants' market power over local transmission facilities as a "rehashing [of] the arguments [that] it and other CLECs are currently advancing in the Commission's ongoing review of special access pricing and provisioning." *Opposition* at 92. They argue that the FCC held in the SBC/AT&T merger that "these claims must be raised in ongoing proceedings not in this merger." *Id.* (footnote omitted). But as Drs. Mitchell and Besen explain, TWTC raises the Applicants' overwhelming dominance over special access facilities not to advocate for special access price and performance regulation *per se*, but rather because this market power increases the incentive and ability for the Applicants to discriminate post-merger through an increased footprint and the loss of a benchmarking firm. *See Besen/Mitchell Decl.* n.15. The Applicants' existing market

²⁸ *See, e.g.*, SBC Comments, WC Dkt. No. 04-313, at 9 (Oct. 4, 2004) ("CLECs have already shown by their wide reliance on special access that they can compete profitably when they use special access as an input."); SBC Reply Comments, WC Dkt. No. 04-313, at 38-40 (Oct. 19, 2004).

power establishes the precondition for the merger specific harms (larger footprint, loss of benchmarking firm) that are the focus of TWTC's advocacy in this proceeding.

Entry Barriers. The Applicants argue that the Commission need not be concerned about the lack of FCC regulation over packetized services (such as Ethernet) because the FCC allegedly held in the *Triennial Review Order* that "there are no significant barriers to deploying such [equipment and services.]" See *Opposition* n.388. This assertion is easily rejected.

First, in eliminating unbundling for the packetized capabilities of hybrid loops in the *Triennial Review Order*, the Commission did not rely on the absence of barriers to entry for these services. Rather, the Commission eliminated packetized UNEs because it found such deregulation would encourage CLEC and ILEC investment in new, advanced facilities and because the Commission retained unbundling for the TDM features of these loops. See *TRO* ¶¶ 289-290. The Commission believed that the continued availability the TDM-based functionality of packetized loops would provide CLECs a viable alternative to packetized loop UNEs. However, the Commission's predictions regarding increased CLEC deployment of packetized loops and the ability of carriers to employ TDM loops for Ethernet services are both unfounded. There is no evidence that the pace of CLEC loop deployment increased after the *TRO*. In addition, because of the added costs and inefficiencies of TDM loops, TWTC cannot utilize AT&T's TDM loops to provide Ethernet services to many customer locations. See *Taylor Reply Decl.* ¶¶ 17-25.

Second, as the Applicants' declarant Parley C. Casto admits, aside from the type of electronics placed on the loop itself, there is no real difference between a finished Ethernet loop

and a TDM loop.²⁹ Therefore the barriers to facilities based entry are largely the same whether the loop carries TDM or Ethernet traffic.³⁰ As the FCC held in the *TRRO*, CLECs cannot deploy DS1 or DS3 facilities in most locations because the revenue opportunity does not compensate for the cost of deploying the fiber. *See TRRO* ¶ 166. Similarly, it is not economic for TWTC to deploy finished Ethernet loops at lower capacities and at longer distances where the cost of construction cannot be recouped. For that reason, as Mr. Taylor explains, TWTC is just as dependant upon AT&T and BellSouth's transmission facilities to provide finished Ethernet services as it is to provide TDM-based services. *See Taylor Reply Decl.* ¶¶ 7-9.

AT&T's Exercise of Market Power. AT&T's behavior in its ongoing negotiations regarding the inclusion of Ethernet services in TWTC's volume and term discount plan confirm that AT&T possesses and exercises substantial and persisting market power over broadband transmission facilities. As Graham Taylor explained in his initial declaration, AT&T has denied, delayed, degraded and overpriced the inputs TWTC needs in order to provide next-generation IP-based services such as Ethernet and IP VPN. The Applicants offer numerous responses to those arguments in a futile effort to show that AT&T has not exercised market power. Those responses are clearly without merit.

First, in his reply declaration, Mr. Casto argues that Mr. Taylor has overstated the problems TWTC faces in expanding its provision of Ethernet services. He argues that TWTC is able to compete in the retail Ethernet market using either "finished" Ethernet loops under

²⁹ *See Reply Declaration of Parley C. Casto, attached to Opposition, ¶ 21 ("Casto Decl.")*.

³⁰ The barriers to loop construction largely stem from the cost of laying the fiber itself, not the electronics used to light the fiber. *See TRRO* n. 493; *TRO* ¶ 381. However, as Mr. Taylor explains, the need to purchase *both* TDM and Ethernet electronics when utilizing AT&T TDM facilities to provide Ethernet often makes it uneconomic to provide Ethernet service at retail using such facilities. *See Taylor Reply Decl.* ¶ 18.

contract prices that are currently being negotiated by TWTC and AT&T or TDM loops that TWTC can purchase under its existing 2005 agreement with AT&T, coupled with Ethernet electronics supplied by TWTC. *See Casto Decl.* ¶¶ 4,10, 15, 19-22. This is not true.

To begin with, TWTC has relied on TDM loops in the past to provide Ethernet service, but this strategy is quickly becoming untenable. As explained in detail in Mr. Taylor's declaration, the high cost of even discounted TDM loops, the need to purchase two sets of electronics (TDM and Ethernet) and the inefficiencies of converting signals from TDM to Ethernet precludes the use of TDM facilities for Ethernet service in most instances. *See Taylor Reply Decl.* ¶¶ 17-25. In even the most advantageous locations, the cost of the AT&T TDM loop itself (not counting additional costs in electronics and maintenance) **[proprietary begin]**

[proprietary end]

See id. ¶¶ 20-23.

Moreover, changes in customer demand patterns are magnifying the significance of the inefficiencies associated with relying on TDM loops. As explained in its petition, TWTC must increasingly serve all of its customers' locations and the high price of TDM loops to provide Ethernet service eliminates many potential customers from TWTC's addressable market for Ethernet service. *Petition* at 48-49. Given that the average TWTC customer has **[proprietary begin]** (see *Taylor Decl.* ¶ 20)

(see *id.* ¶ 22), **[proprietary end]** it is clear that TWTC must increase substantially the number of locations it must serve per customer in order to meet changing customer demands. In fact, TWTC's customers currently have **[proprietary begin]**

[proprietary end] in areas where TWTC does not have any fiber deployed at all. *See id.* ¶ 21.

REDACTED - FOR PUBLIC INSPECTION

TWTC would need to serve all of those locations today exclusively via ILEC local transmission facilities. Given that it is only economically rational to purchase AT&T TDM loops to provide Ethernet service to TWTC customers **[proprietary begin]**

, **[proprietary end]** many of these customer locations cannot be served using AT&T TDM loops. This could very well lead to the loss of current TWTC Ethernet customers and the inability to serve many prospective Ethernet customers.

Nor is it possible for TWTC to rely to any significant degree on “finished” Ethernet loops offered by AT&T, **[proprietary begin]**

[proprietary end]

See Taylor Reply Decl. ¶ 8. TWTC cannot rely on AT&T’s finished Ethernet services at AT&T’s extremely high tariffed rates, and indeed, TWTC has never purchased any circuits at these rates. In those few instances where TWTC is able to obtain finished Ethernet loops from non-ILEC wholesalers, such wholesalers’ prices are **[proprietary begin]**

[proprietary end] *See id.*

As Mr. Taylor shows, **[proprietary begin]**

[proprietary end] TWTC offers a range of Ethernet rates at retail that it believes, based on competition in the marketplace and its own costs, enable it to be profitable. TWTC’s rates range from its **[proprietary begin]**

[proprietary end] Because TWTC operates in a competitive retail market, the more competition in a certain area or for a certain customer, the lower TWTC’s retail prices must be

REDACTED - FOR PUBLIC INSPECTION

for it to remain competitive. It is likely that as competition continues to intensify over time, TWTC will be forced to offer ever lower retail Ethernet prices.³¹

Based on Mr. Taylor's analysis, **[proprietary begin]**

Id. ¶ 12.

See id. ¶ 11.

See id. ¶ 15.

See id. ¶ 11.

Id. ¶ 13

(emphasis added).

³¹ **[Proprietary Begin]**

[Proprietary End] *See Taylor Reply Decl.* n.6.

Id. ¶ 16.

See id. ¶ 7.

See Taylor Decl. ¶ 37.

See

32

See id. ¶ 14.

See id.

id.

See Taylor Reply Decl.

¶ 27.

See id.

See

id.

See

id.

See id.

See id. ¶ 7.

[proprietary end]

AT&T's exorbitant "off-the-shelf" finished Ethernet prices also demonstrate its market power. AT&T sets its month-to-month and term tariff finished Ethernet rates at absurdly high levels. Indeed, the latter prices are so high that, as Mr. Casto notes, few carriers purchase any

REDACTED - FOR PUBLIC INSPECTION

Ethernet facilities from AT&T. *See Casto Decl.* ¶ 18. Such a pricing structure comports with economic theories regarding the behavior of monopolists. As former FCC Chief Economist Joseph Farrell explains: “[W]hen a monopoly offers proportional or relative discounts off its undiscounted prices in order to induce customers to agree to exclusionary provisions, it has an incentive to set the undiscounted price above even the monopoly level (because rather than simply deterring demand, an increase above the monopoly level steers customers into the discount plans and also brings the discount prices closer to the monopoly level).”³³

Second, the Applicants attempt to show that non-price terms in its volume/term agreements are not an exercise of market power. In its *Petition*, TWTC argued that certain volume/term special access contracts explicitly demand that four percent of a customer’s circuit commitment with legacy SBC must be transferred from a competitive wholesaler. *See Petition* at n.23.³⁴ Such provisions are anticompetitive and indicative of AT&T’s market power over special access. The Applicants respond that the requirement that competitors limit their purchases from non-ILEC providers was included in only one contract arrangement and that that contract is not representative of most plans. *Opposition* at 31-32. Although it may be true that most of AT&T’s contracts do not explicitly require a reduction in purchases from CLEC wholesalers, the presence of a MARC in many of AT&T special access contracts (including its

³³ Reply Declaration of Joseph Farrell on Behalf of CompTel, attached to Reply Comments of CompTel, Global Crossing and NuVox, WC Dkt. No. 05-25, ¶ 4 (July 29, 2005).

³⁴ *See* CompTel/ALTS, Global Crossing North America, Inc., and NuVox Communications Comments, WC Dkt. No. 05-25, at 18 (June 13, 2005) (noting that SBC Tariff No. 15 “requires that a ‘minimum of 4% of [the annual commitment] must come from services previously provided by a carrier other than Southwestern Bell Telephone Company and its affiliates.’ Failure to document this 4% minimum transfer of service will require customers to suffer the full termination penalty under the tariff – repayment of all discounts given plus 25% of the committed revenue for each remaining year.”).

popular “MVP” plan),³⁵ has the exact same effect. [proprietary begin]

[proprietary end] See *Taylor Reply Decl.* ¶ 7.

In addition, AT&T’s current contract with TWTC does not permit TWTC to purchase more than a minimal number of UNEs. If TWTC fails to meet this condition, it loses the offered discounts.³⁶ TWTC’s contract is not unique; numerous AT&T contract tariffs including the “MVP” plan contain a similar requirement.³⁷ The FCC found that 11 CLECs subscribed to the MVP plan in SBC’s region prior to its merger with AT&T.³⁸ Although TWTC is one of the few carriers that does not purchase UNEs, it seems extremely unlikely that at least 11 carriers in SBC’s region would willingly give up their right to obtain transmission facilities at forward looking prices if AT&T did not continue to retain market power over the special access inputs needed by carriers to compete.

Third, Mr. Casto argues that TWTC’s willingness to sign its 2005 special access contract and its announcement at the time that the deal “strengthens Time Warner Telecom’s ability to compete effectively for the nationwide business market” proves that TWTC happily accepted all

³⁵ See SWBT Tariff F.C.C. No. 73 § 38.3(C) (explaining the MARC provisions of the MVP contract tariff).

³⁶ See SWBT Tariff F.C.C. No. 73 § 41.48.3 (E) (explaining that CLEC customers can only purchase two percent of their access services from SWBT as UNEs or they will lose the discount on special access services).

³⁷ See SWBT Tariff F.C.C. No. 73 § 38.3(C) (explaining that CLEC customers can only purchase five percent of their access services from SWBT as UNEs or they will lose the discount on special access services).

³⁸ *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, Memorandum Opinion & Order, 20 FCC Rcd 18290, ¶ 43 (2005).

REDACTED - FOR PUBLIC INSPECTION

of its terms. *See Casto Decl.* ¶ 20. According to AT&T, TWTC's agreement to sign the contract is *prima facie* evidence that all of the terms in the contract are reasonable. This is fatuous.

TWTC simply has no choice but to purchase local transmission facilities from AT&T. TWTC decision to sign a volume-term agreement with discounts only shows that those discounts are preferable to higher AT&T tariff prices for the same inputs; it in no way demonstrates that the somewhat reduced prices and other terms and conditions of the agreement are reasonable or even close to those that would prevail in a competitive market.³⁹

For example, Mr. Casto alleges that **[proprietary begin]**

See Casto Decl. ¶ 43.

See Taylor Reply Decl. ¶ 29.

See id.

[proprietary end]

The Commission has recognized in other contexts that the mere signing of a contract between two parties with unequal bargaining power does not *ispo facto* mean that the contract terms are just and reasonable. For example, the Commission allows carriers to demand arbitration with the Commission *following* the signing of a pole attachment agreement. The Commission recognized that utility pole owners have little incentive to negotiate on reasonable

³⁹ *See Besen/Mitchell Decl.* ¶ 14. ("Entrants need interconnection with ILECs such as AT&T and BellSouth far more than do AT&T and BellSouth need interconnection with CLECs such as Time Warner Telecom. This is because AT&T and BellSouth serve far more end users than any CLEC. If negotiations over interconnection were to break down, a CLEC would likely be forced out of business as the result of being unable to offer its customer the ability to make calls to, and receive calls from, the ILEC's network.").

terms and conditions because of the extreme imbalance in bargaining power. As the

Commission explained:

In the Local Competition Order, the Commission addressed the requirement of Section 251 that requires an ILEC to provide interconnection and other rights to new entrants, and observed that new entrants have little to offer the incumbent. Rather, these new competitors seek to reduce the incumbent's subscribership and weaken the incumbent's dominant position in the market. An ILEC is likely to have scant, if any, economic incentive to reach agreement. In the Local Competition Order, the Commission determined that a utility stood in a position vis-à-vis the competitive telecommunications provider seeking pole attachment agreements that was virtually indistinguishable from that of the ILEC with respect to a new entrant seeking interconnection agreements under Sections 251 and 252 of the 1996 Act. We find that a utility's demand for a clause waiving the licensee's right to federal, state, or local regulatory relief would be per se unreasonable and an act of bad faith in negotiation. In particular, a request that a pole attachment agreement include a clause waiving statutory rights to file a complaint with the Commission is per se unreasonable.⁴⁰

Similarly, in order for TWTC to obtain a contract for finished Ethernet services which provides even the high rates offered by AT&T, it will likely have to sign a contract with many unjust and unreasonable provisions, including a requirement to purchase other competitive services, such as switched long distance, at above market rates.

3. The Increased Size of the Applicants Footprint Will Unquestionably and Substantially Increase the Applicants' Incentive to Engage In Exclusionary Conduct

In light of the Applicants' continuing market power over the facilities needed by competitors to provide services to the enterprise market, their increased footprint due to merger will increase their incentive and ability to engage in exclusionary behavior. As Drs. Besen and Mitchell explain, the merger of two ILECs enables the merged company

⁴⁰ *Implementation of Section 703(e) of the Telecommunications Act of 1996*, Report and Order, 13 FCC Red 6777, ¶ 21 (1998), *aff'd in part, rev'd in part*, *Gulf Power Co. v. FCC*, 208 F.3d 1263 (11th Cir. 2000) (footnotes omitted).

to capture more of the benefits of their exclusionary behavior making such behavior more attractive to the merged firm. *See Besen/Mitchell Decl.* ¶ 39.

When CLECs with a national scope such as TWTC rely on multiple ILECs for inputs to provide service, the discrimination of one ILEC can harm the CLEC's ability to compete in other regions, but the discriminating ILEC can only capture a portion of these effects. *See id.* ¶ 40. AT&T's discriminatory behavior can both raise the costs of a national CLEC like TWTC and reduce the demand for TWTC's services throughout the country. *See id.* ¶¶ 45-46. AT&T's discrimination can also impact TWTC's economies of scale and scope, increasing its costs nationally. *See id.* ¶ 48. Discrimination in one region can lower the return on investment that TWTC would obtain in all of its markets from product development and research and development, thereby inhibiting both. *See id.* ¶¶ 46-47, 57. However, AT&T currently captures virtually none of the benefits of its discrimination that "spill-over" into BellSouth's region. Following the merger, the merged company can internalize the benefits in the BellSouth region, increasing the incentive and ability for the merged company to engage in discrimination, especially against CLECs such as TWTC which compete in both AT&T's and BellSouth's regions. *See id.* ¶ 49.

Indeed, TWTC's market presence in both AT&T's and BellSouth's regions makes it especially vulnerable to the merged company's increased incentive and ability to discriminate post-merger. For example, depending upon the metric used, a merged AT&T/BellSouth will have a **[proprietary begin]** **[proprietary end]** percent larger footprint in those markets served by TWTC than AT&T had prior to the merger. *See id.* ¶ 55. Moreover, many of TWTC's customers have multiple locations in both

regions (*see id.* ¶ 56), and as explained previously, **[proprietary begin]**

[proprietary end] come from customers that are located in both AT&T and BellSouth's regions. *See Petition* at 5. This share will only increase as TWTC is pressured by market demand to increasingly serve most, if not all of its customers' locations across the country. *See id.* The heavy presence of TWTC's customers in both BellSouth's and AT&T's markets materially increases the ability and incentive for the merged company to engage in discrimination against TWTC and other similarly situated CLECs. *See Besen/Mitchell Decl.* ¶ 21.

4. Existing Regulations Will Not Ameliorate the Effects of an Increased Footprint and Loss of a Benchmarking Firm

The Applicants' increased incentive to engage in anticompetitive conduct combined with competitors' increased reliance on the Applicants' local transmission facilities to provide IP-based services would create an even greater need for regulation. But, of course, the elimination of a benchmark RBOC would make that regulation far less effective.

Consequences of the Merger. As Drs. Besen and Mitchell explain, there are substantial public interest harms that will result from the loss of BellSouth as a benchmarking firm. The merger will result in a loss of information provided to regulators in several ways. *First*, a merged firm may adopt a common practice and therefore regulators will lose a source of independent RBOC behavior. *Second*, even where the firm retains somewhat different practices among its legacy companies, it may only report its practices at the firm level, thus providing less information. *Third*, even if the merged company reports "sub-company" data, this data is often less useful to regulators. *See id.* ¶ 86.

Drs. Besen and Mitchell explain in detail how this loss of information caused by the merger diminishes the ability of regulators to perform both "best-practice" and "average practice

benchmarking.” For example, assuming four RBOCs,⁴¹ the loss of one of these four to merger would reduce the likelihood of a firm adopting a best practice (different from the remaining firms) by half. *See id.* ¶ 91. This impact on “average practice benchmarking” caused by the merger is also severe for two reasons. *First*, with fewer firms and therefore data points, it becomes more difficult to calculate an “average.” *See id.* ¶ 93. *Second*, this loss of information will (rightly) reduce the confidence of regulators in making the decision and therefore make them less likely to employ average practice benchmarking at all. *See id.*

The Inadequacy of Existing Regulation. Notwithstanding the harmful consequences of the merger for regulation, the Applicants blithely assert that benchmarking is unnecessary. For example, the Applicants’ argue that, even if they retain “residual market power over certain DS_n-level facilities,” the “full implementation” of Sections 251 and 271 prevents any further discrimination. This is purportedly so because (1) local transmission facilities are now available to TWTC and other competitors as UNEs and (2) the Applicants are subject to performance standards for UNEs as well as other interconnection and access services for which state and federal regulatory processes are mature. *See Opposition* at 92-95. These assertions are makeweight.

To begin with, as explained, advanced packetized services such as Ethernet loops are unavailable as UNEs. Under the impairment tests established in the TRRO, DS_n loops and transport are also unavailable as UNEs in wire centers in which there is little assurance that competitive opportunities exist. Indeed, the Commission’s reliance on the number of collocators

⁴¹ As we argued in our *Petition*, this merger will result in the loss of 1 out of 3 RBOC benchmark firms because Qwest is too small and different than the remaining RBOCs to provide a benchmark comparison in many cases. *See Petition* at 62-63.

in a wire center to predict whether a competitor has or could construct a lateral facility to a building is obviously extremely unreliable. TWTC's experience is that there are many buildings in those areas where the FCC has determined that CLECs are not "impaired" without access to unbundled loops to which it is not economic to deploy laterals due to the absence of adequate revenue opportunities or other entry barriers. This is true even in wire centers in which TWTC has deployed transport and collocated equipment in an ILEC central office.

But even where DSn loops and transport are subject to *de jure* unbundling requirements, ILEC exclusionary conduct has often prevented their *de facto* availability. As TWTC explained previously, the ILECs have relied effectively on simple refusals to deal to prevent CLECs from exercising their rights to UNEs. *See Petition* at 43. Such "slow rolling" of inputs needed by competitors is extremely difficult to detect and remedy through regulation. For example, the FCC recognized "incumbent LECs [relying on largely specious claims of no facilities available] sometimes do not permit competitors to obtain new circuits as UNEs, and only permit the competitive LEC to convert facilities obtained as special access to UNEs after a 'holding period' of one to several months." *TRRO* ¶ 64 (footnote omitted). Moreover, "Verizon sometimes imposes large, nonrecurring charges on UNEs that are not imposed on special access." *Id.* n.183 (internal citations omitted). BellSouth and AT&T (SBC) have engaged in similar tactics.⁴² For these reasons, the Commission determined that many carriers purchase special access because ILECs refused to offer UNEs in a non-discriminatory fashion.

⁴² *See, e.g., Falvey Decl.* ¶ 38 ("Xspedius has recently experienced a significant increase in the number of UNE orders rejected by SBC Texas because there were 'no facilities' available, and it would ostensibly require more than 'routine network modifications.' Yet when ordered as Special Access, the same circuits are provisioned with alacrity."); *id.* ¶ 39 (noting that, "when Xspedius attempted to convert special access circuits to UNE loops," BellSouth charged Xspedius an over \$800 per circuit non-recurring charge).

REDACTED - FOR PUBLIC INSPECTION

As TWTC has also explained, contrary to the Applicants' assertion, the Applicants' incentive to discriminate is not eliminated or even reduced after Section 271 approval has been granted. As the FCC observed, the grant of Section 271 authority *creates* incentives to discriminate against interexchange carriers. *See Petition* at 31. The proposed merger will increase this incentive because more traffic will both originate and terminate in the merged company's territory, allowing the internalization of external effects.⁴³ As the Commission concluded, "[e]ven after receiving section 271 authority, the threat of discrimination remains in force." *SBC/Ameritech Order* ¶ 242.

The Applicants argue further that benchmarking is not necessary for the regulation of special access because "TWTC does not cite a single recent instance in which [RBOC-to-RBOC benchmarking] has been relied upon [] concerning either the lawfulness or the adequacy of an ILEC's provisioning of special access." *Opposition* at 106. This is like arguing that law enforcement is not needed because there are no recent examples of police apprehending criminals. The absence of recent regulatory detection of unreasonable special access rates and practices does not mean that such detection should not and would not occur in the future (indeed, it should occur now given supracompetitive RBOC special access rates). As the Applicants recognize, the entire point of benchmarking is to monitor differences in RBOC behavior to determine what a reasonable form of regulation should be *in the future*. *See Opposition* at 105. As long as the Applicants retain their market power over loops, independent benchmarking

⁴³ *Application of GTE Corp. and Bell Atlantic Corp. for Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, Memorandum Opinion and Order, 15 FCC Rcd 14032, ¶ 188 & n.429 (2000) ("*Bell Atlantic/GTE Order*").

REDACTED - FOR PUBLIC INSPECTION

comparisons among multiple RBOCs are needed to determine both whether regulation is necessary in the first place and what form that regulation should take.

The Applicants are correct that benchmarking currently does not guide special access rate regulation. But this again misses the point. As the Applicants state, “TWTC recognizes that the relevant issue is whether there is a need for benchmarking ‘going forward.’” *Id.* As TWTC argued, in considering future regulation of ILEC special access, the FCC has asked for evidence based on industry wide productivity that will place it in a position to be able to perform average practice benchmarking to set ILEC price cap rates in the future. *See Petition* at 59-60. With the reduction in the number of RBOCs, the ability of the FCC to perform such average practice benchmarking will be drastically diminished or eliminated entirely.

The Applicants argue that “a host of company specific factors” prevent the use of RBOC special access *prices* to set prices prospectively. *Opposition* at 108. But at least as to price caps, the FCC has not set prices based on an average of ILEC *prices*, but rather based on industry-wide *productivity*. Because RBOCs’ regions span huge swaths of both urban and rural areas, any differences in productivity between carriers cannot be based on conditions in a particular locality. Because the FCC requested productivity data from the RBOCs, there is every indication it will need to use average-practice benchmarking, and, in doing so, will compare RBOCs’ productivity, not their prices. In any event, benchmarking is fully appropriate as a basis for comparing ILEC prices for special access *rate structures* (such as **[proprietary begin]**

[proprietary end] and even rate levels so long as any relevant differences among carriers are accounted for.

Regulators' Continued Reliance on Benchmarking. The Applicants criticize and attempt to distinguish the examples of benchmarking TWTC provided in its petition, yet these attacks are misplaced. *First*, the Applicants argue that “three of the cases TWTC cites are clearly irrelevant because they pertain to an RBOC’s satisfaction of the Section 271 checklist.” *Id.* at 103. Yet, as TWTC noted in its petition to deny, the FCC has held that benchmarking provides an important tool to prevent “possible backsliding by RBOCs” in their compliance with the provisions of Section 271. *See SBC/Ameritech Order* ¶ 148.

Second, in an attempt to show that regulators no longer employ benchmarking, the Applicants mischaracterize several of the cases that TWTC cited to show that states and the FCC continue to benchmark one RBOC against another. The Applicants argue that the Indiana commission did not rely on benchmarking to order SBC to carry Level 3’s traffic over a single trunk group. Instead they assert that “the Indiana Commission never mentions Level 3’s benchmarking argument in its analysis” (*Opposition* n.423.). Regardless of whether the commission’s actual conclusion was in the “position of the parties” section, rather than in the portion entitled “conclusion,” the Indiana commission clearly took BellSouth’s activities into account in reaching its conclusion that SBC was required to provide the same level of service. As the commission explained,

BellSouth voluntarily agreed with Level 3 to exchange all traffic, including interLATA toll and IP Enabled Traffic, *over a single trunk group*. This point alone substantially if not completely justifies approval of Level 3’s request. According to FCC Rule 51.321(c), ‘a previously successful method *of obtaining interconnection* or access to unbundled network elements at any particular premises *or point on any incumbent LEC’s network is substantial evidence that such method is technically feasible* in the case of substantially similar network premises or points.’ (emphasis in original)⁴⁴

⁴⁴ *Level 3 Communications, LLC’s Petition for Arbitration Pursuant to Section 252(b) of the Communications Act of 1934, As Amended by the Telecommunications Act of 1996, and the*

REDACTED - FOR PUBLIC INSPECTION

The Applicants argue that the Colorado commission did not use benchmarking as a basis for requiring Qwest to submit to a particular billing practice. Instead, the Applicants argue that the Colorado commission “merely held that the parties should negotiate a separate billing arrangement.” *Opposition* at n.435. The Applicants neglect to mention that the Colorado commission mandated that Qwest negotiate such an arrangement because SBC had separately negotiated a billing agreement with AT&T, a clear example of benchmarking:

AT&T seeks to have all arrangements with Qwest for billing and collection dealt with in the context of a separate agreement...AT&T notes that it received better terms than Qwest proposes in a separately negotiated contract with SBC, and argues that Qwest should not be allowed to leverage this arbitration to avoid such a negotiation or to force its one-sided terms on AT&T. We are persuaded by AT&T that billing for alternatively billed calls is better dealt with through a separate agreement. We note that AT&T has entered into a separate agreement for alternatively billed calls with SBC Communications Inc. This separate agreement is much more elaborate than Qwest's proposed interconnection agreement language.⁴⁵

The Applicants argue that the FCC rejected Verizon's position with respect to structure sharing in the *Virginia TELRIC Arbitration Order*, because of “Verizon's own cost evidence.” *Opposition* at 104. This is true, but it is irrelevant to the argument that the FCC engaged in RBOC-to-RBOC benchmarking. The cost model that the FCC *actually chose* for structure

Applicable State Laws for Rates, Terms, and Conditions of Interconnection with Indiana Bell Telephone Company d/b/a SBC Indiana, Opinion, Cause No. 42663 INT-01, 2004 Ind. PUC LEXIS 465, at *67-8 (Dec. 22, 2004).

⁴⁵ *Petition of Qwest Corporation for Arbitration of an Interconnection Agreement with AT&T Communications of the Mountain States, Inc. and TCG-Colorado Pursuant to 47 U.S.C. § 252(b)*, Initial Commission Decision, Dkt. No. 03B-287T, Decision No. C03-1189, 2003 Colo. PUC LEXIS 1149, at *149 (Oct. 14, 2003).

sharing, put forth by AT&T, was based upon BellSouth's cost study submitted to the Kansas and Louisiana state Commissions.⁴⁶

Despite the Applicants' assertions to the contrary, it remains clear that states and the FCC continue to use benchmarking analysis, despite the fact that "Sections 271 and 251" have been "fully implemented."

Relevance of Benchmarking to Advanced Services. In a rather lame attempt to divert the Commission's attention away from the critical consequences of the proposed merger for regulation, the Applicants imply that all provisioning issues regarding advanced services have been resolved and that past reliance on benchmarking to resolve these disputes is therefore irrelevant.⁴⁷ This is of course not true. Telecommunications networks are not frozen in time. As competitors develop new services they require new inputs from ILECs. Mr. Taylor provides numerous clear examples of new inputs required for the provision of IP-based services. The difficulty that TWTC has experienced obtaining reasonable interconnection for Ethernet services

⁴⁶ See *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration in the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc.*, Memorandum Opinion and Order, 18 FCC Rcd 17722, ¶¶ 289-291 (2003).

⁴⁷ See *Opposition* at 102 ("[T]he market opening requirements of the 1996 Act that the Commission previously regarded as too immature in 1999 and 2000 to supplant the need for benchmarking against multiple independent RBOCs have now been 'fully implemented.' Thus, the provisioning disputes over the services that the Commission regarded in 1999-2000 as candidates for RBOC-to-RBOC benchmarking comparisons (e.g., loop testing and provisioning, number portability, cageless collocation, technically feasible points of interconnection) have all but disappeared. Both ILEC unbundling and obligations concerning the OSS and other systems that must be used to provision UNEs are well-defined from both a technical and regulatory perspective.") (footnotes omitted).

REDACTED - FOR PUBLIC INSPECTION

and the difficulties that TWTC has had in attempting to obtain CoS and QoS for its IP VPN services only underscore the need for continuing RBOC benchmarking. *See generally Taylor Reply Decl.; Taylor Decl.* **[proprietary begin]**

[proprietary end] demonstrates that RBOC-to-RBOC comparisons are particularly useful in detecting discrimination for advanced services. More generally, the inability of the FCC to “foresee every possible type of discrimination, especially with evolving technologies,” (*SBC/Ameritech Order* ¶ 206), makes “reliance on existing regulatory safeguards [] misplaced.” (*Id.*)

The Applicants’ misunderstanding of the forward-looking role of benchmarking can be seen in their criticism of TWTC’s use of several of the benchmarking decisions that pertain to “line splitting” and NGDLC unbundling. *See Petition* at 54-55. The Applicants argue that these cases are irrelevant to the continued need for benchmarking because they involve “issues that were settled by the Commission’s unbundling orders.” *Opposition* at 103 (footnotes omitted). But TWTC does not cite these examples to indicate that the same problems exist today but rather to show the effectiveness of benchmarking (the Applicants themselves concede this point (*see id.*) by claiming that the problems first raised in multiple state proceedings have been resolved by an FCC rule) and to show that state and federal authorities continued to use benchmarking following the FCC’s previous RBOC merger orders.

Even the Applicants admit that states often update their performance requirements to take into account changed circumstances. *See id.* at n. 389. Regulators cannot have experience regulating services that are being developed for the first time, and current regulations and

regulatory experience will provide little help in fashioning such regulation. As Drs. Besen and Mitchell explain:

[Even if the Commission were to believe that it can prevent serious abuses in the standard] provision of ‘plain-vanilla’ access...[future interconnection and access issues will be much more difficult to resolve. For existing interLATA arrangements,] policy makers have built up experience over a number of years in detecting and addressing problems [with the provision of access...The situation is quite different] for access that is needed to support new services...For these arrangements, policy makers do not have the benefit of long experience in detecting and correcting problems...if the merged AT&T and BellSouth were refused to provide efficient new access arrangements, or delayed or slowed deployment of those arrangements, or reduced the quality of access below the efficient level, regulators would face significant difficulties in detecting these distortions and inducing the merged entity to correct its misbehavior. *Besen/Mitchell Decl.* ¶¶ 35-36.

The problems that TWTC has encountered in obtaining Ethernet transmission facilities and CoS and QoS for IP VPN service illustrate exactly this point.

Applicants’ Incentive to Collude. As with so many other issues, the Applicants respond to TWTC’s assertion that the merger will increase their incentive to cooperate to undermine the effectiveness of regulation by mischaracterizing the problem. As TWTC explained (*see Petition* at 66-67), the Commission held in a previous RBOC merger order that a reduction in the number of benchmarking firms may “increase the incentive and opportunity for collusion and concealment of information among the few remaining incumbent LECs.” *SBC/Ameritech Merger Order* ¶ 184. The Applicants respond that all four RBOCs are aggressively competing in each other’s territory (*see Opposition* at 109), but this is of course irrelevant to TWTC’s argument. As TWTC explained in its petition, the type of collusion and coordination at issue involves (1) an agreement to settle on a lower benchmark or (2) concealing information concerning operating practices and dealings with competitors. *See Petition* at 66 (citing *SBC/Ameritech Merger* ¶¶ 121-123). As Drs. Besen and Mitchell explain, there is little doubt

that the proposed merger would increase the likelihood of this kind of conduct. *See Besen/Mitchell Decl.* ¶¶ 120-124. The Applicants do not even attempt to argue otherwise.

The Insufficiency of Parity Regulation. The Applicants imply that there is no need for benchmarking because the FCC has purportedly held that parity standards are always superior.⁴⁸ This argument is belied by the evidence and past FCC precedent. As the Joint Competitive Industry Group (“JCIG”) has explained in the context of special access, many states have adopted JCIG’s recommended performance metrics⁴⁹ which, as the Applicants acknowledge, contain many objective benchmarks. *See Opposition* n.447. As the Commission has recognized with respect to 271 compliance, objective, non-parity standards are required to monitor RBOC performance: “Where no retail analogue exists to compare SWBT’s performance towards competing carriers to SWBT’s performance to its retail operations, we evaluate SWBT’s showing to ascertain whether SWBT affords competing carriers a meaningful opportunity to compete. As a result, *we sometimes rely on performance measurements that use a benchmark instead of a parity standard.*” (emphasis added).⁵⁰

⁴⁸ *See Opposition* at 109-110 (regarding the use of parity regulation with respect to special access services).

⁴⁹ *See JCIG Ex Parte* Presentation, submitted by Gil M. Strobel, Counsel, JCIG, to Marlene Dortch, Secretary, FCC, WC Docket No. 01-321 (June 7, 2004) (updating FCC staff on the status of state actions requiring performance measurements of ILEC special access performance, including adoption of JCIG plans in many states).

⁵⁰ *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, Memorandum Opinion and Order, 16 FCC Rcd 6237, n.514 (2001), *aff’d in part, remanded, Sprint Communications Co. v. FCC*, 274 F.3d 549 (D.C. Cir. 2001).

REDACTED - FOR PUBLIC INSPECTION

Parity standards are useless for services (1) not yet offered by the RBOC⁵¹ or (2) for which the competitor requires an input that the RBOC does not require when providing the service at retail.⁵² These conditions are most likely to occur for new and innovative services. As explained by Drs. Besen and Mitchell, a CLEC “can offer [an innovative] service efficiently only if it obtains a particular type of access arrangement from the ILEC. The ILECs’ refusal to provide that access in a timely fashion can raise the entrant’s costs or reduce the quality of its service offerings, thus limiting its ability to compete.” *Besen/Mitchell Decl.* ¶ 26. Regulation “can only imperfectly detect and correct such conduct,” and the ability to fashion any regulation to restrict that conduct will be further reduced by diminishing the number of benchmarking firms. *Id.* ¶ 34. Moreover, the likelihood of harm with respect to advanced services is exacerbated because the Applicants already have an increased incentive to “deny special accommodations required by competitive LECs seeking to offer innovative advanced services that the incumbent may not even offer.” *SBC/Ameritech Order* ¶ 107 (footnote omitted). The Applicants do not debate any of these propositions except to say that they no longer have market power with respect to advanced services, which is untrue as explained above. *Opposition* at 108.

TWTC’s experience with AT&T in attempting to obtain inputs for IP-based services illustrates the insufficiency of parity regulation. **[proprietary begin]**

See Taylor Reply Decl. ¶¶ 38-40; *Taylor*

Decl. ¶ 42.

⁵¹ For example, the FCC found that RBOC discrimination over the inputs needed by CLECs to provide DSL service (a service which CLECs generally offered before ILECs), “delayed competitive provision of these services.” *SBC/Ameritech Order* ¶ 197.

⁵² In either case, there is no retail analog. *See Besen/Mitchell Decl.* ¶¶ 103-106.

REDACTED - FOR PUBLIC INSPECTION

See Taylor Reply Decl. ¶¶ 30-32; Taylor Decl. ¶¶ 39-41.

See Taylor Reply Decl. ¶

33; *Taylor Decl. ¶ 38. [proprietary end]* These services are only required by wholesale purchasers like TWTC. Parity regulation is therefore of no assistance to regulators in limiting the Applicants' opportunities to exploit competitors' reliance on these services to provide IP-based services.

[proprietary begin]

See Taylor Decl. ¶ 41.

See Taylor Reply Decl. ¶¶ 31-32.

[proprietary end]

TWTC also requires CoS and QoS for its IP VPN traffic that traverses AT&T's IP network facilities. This service is essentially an interconnection service, that, by definition, AT&T need only provide to other carriers at wholesale (and not to itself). **[proprietary begin]**

(see

Taylor Decl. ¶ 42)

See Taylor Reply Decl. ¶¶ 38-40.

See id. ¶¶ 39-40.

See id. ¶ 39.

See id.

[proprietary end] CoS and QoS for IP VPN traffic that traverses two carriers' IP networks is again an example of where benchmarking regulation can be used and in which parity regulation is of no use.

[proprietary begin]

(*see id.* ¶ 33),

See id.

[proprietary end]

It is also important to point out that AT&T apparently offers Ethernet as an intrastate service in some cases (*see id.* ¶ 34) and is therefore able to set its retail prices far below even the rates that would apply if retail customers (again, such customers do not pay for cross-connects) purchased the service under AT&T's federal tariff or its negotiated federal contract tariffs. This

REDACTED - FOR PUBLIC INSPECTION

is because AT&T's intrastate Ethernet services are not subject to meaningful regulation. For example, in Ohio, the terms of the contracts for intrastate services AT&T offers to its retail customers must be made available to all "similarly situated customers." OAC § 4901:1-6-19(A). However, AT&T argues that TWTC is not "similarly situated" to its own retail end users (because it is a wholesale customer) and therefore, cannot not take advantage of these contract prices.

In many states there is no way for regulators to even detect whether AT&T is offering much lower rates than it offers under its FCC tariff or in its negotiated FCC contract tariffs. Again, Ohio illustrates the point. In the past, AT&T was required to file intrastate contracts with the Ohio commission. *See id.* Without issuing a formal order or waiver, the PUC now allows AT&T to forego submission of these contracts and allows AT&T merely to file a spreadsheet that lists the contract number, type of service, length of contract, and tariff references.⁵³ Other AT&T region states, such as Illinois, have similar statutory provisions which preclude in most cases CLECs from taking advantage of contract rates⁵⁴ Therefore, if AT&T is placing TWTC

⁵³ *See e.g.*, Ohio PUC, Case No. 06-0931-TP-CTR, *available at* [http://dis.puc.state.oh.us/dis.nsf/\(CaseNoLookup/06-0931?OpenDocument](http://dis.puc.state.oh.us/dis.nsf/(CaseNoLookup/06-0931?OpenDocument) (listing weekly contract spreadsheets filed by AT&T Ohio). In addition to the spreadsheet, AT&T must file an affidavit stating that the total price of the contract (including all contracted services whether regulated or unregulated) exceeds the total incremental cost of all regulated contracted services. *See id.* This affidavit requirement is meant to prevent AT&T cross-subsidizing its competitive services with its regulated services; it in no way precludes AT&T from providing special access services to its end users at a rate well below its FCC tariff or FCC contract rates.

⁵⁴ Under Illinois law, a telecommunications carrier can negotiate to provide competitive telecommunications services, including intrastate special access, without regard to any tariffs it may have on file with respect to such services. *See* 220 ILCS § 5/13-509. Carriers must file a notice of the negotiated contract (*see id.*), but CLECs have no way of knowing what the prices in the contract are as the contracts themselves are generally accorded confidential treatment. *See id.* More importantly, carriers would obviously have no right to opt-into these rates.

REDACTED - FOR PUBLIC INSPECTION

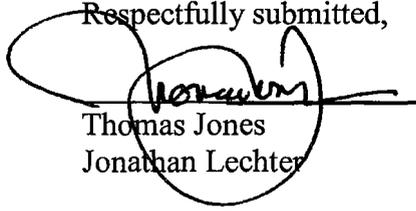
and other CLEC wholesale customers in a price squeeze through gaming the tariffing system, this conduct cannot be addressed through parity regulation.

The Applicants' only response to TWTC's argument that parity is insufficient and benchmarking crucial for the regulation of advanced services is to cite the recent RBOC/IXC merger orders in which the Commission found that a "wide and heterogeneous array of competitors 'ensure that there is sufficient competition' for Frame Relay, ATM, and Gigabit Ethernet and similar based transmission services." *Opposition* at 108 (citations omitted). But as explained above, the real source of the Applicants' ability and incentive to discriminate (incentives upon which AT&T unquestionably acted) is their control over local transmission facilities. That market power remains today and the proposed merger would only increase it by eliminating AT&T as an independent competitor in the BellSouth region. The Applicants have no answer to this point.

As TWTC observed in its petition, the Commission stated in its review of the last RBOC mergers that "a merger that reduced the number of major incumbent LECs from four to three would so severely diminish the Commission's ability to benchmark, it is difficult to imagine that any potential public interest benefit could outweigh such a harm." *Petition* at 50 (citing *Bell Atlantic/GTE Order* ¶ 170). The Applicants respond that "such diversity needed to be preserved only 'during the transition to competition.'" *Opposition* at 101 & n.117 (citing *Bell Atlantic/GTE Order* ¶ 172). TWTC agrees. However, as TWTC has shown, that transition is nowhere near complete. Nor does the proposed merger implicate potential public interest benefits that could possibly outweigh the harm caused by the elimination of benchmarking regulation.

REDACTED - FOR PUBLIC INSPECTION

Respectfully submitted,

A handwritten signature in black ink, appearing to be "Thomas Jones" and "Jonathan Lechter", is written over a horizontal line. The signature is partially enclosed by a large, loopy circular scribble.

Thomas Jones
Jonathan Lechter

Willkie Farr & Gallagher LLP
1875 K Street, N.W.
Washington, D.C. 20006
(202) 303-1000

ATTORNEYS FOR TIME WARNER TELECOM

August 8, 2006

REDACTED-FOR PUBLIC INSPECTION

ATTACHMENT A

Reply Declaration of Graham Taylor

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

In the Matter of)	
)	
AT&T Inc. and BellSouth Corporation)	WC Docket No. 06-74
Applications for Approval of)	
Transfer Of Control)	
)	

**REPLY DECLARATION OF GRAHAM TAYLOR
ON BEHALF OF TIME WARNER TELECOM, INC.**

I. INTRODUCTION

1. My name is Graham Taylor. My business address is 10475 Park Meadows Drive, Littleton, CO 80124.

2. I am Senior Vice President for Marketing at Time Warner Telecom, Inc. ("TWTC"). I have over 25 years of telecommunications industry experience in marketing, sales, corporate development, management and operations. I spent 15 years specifically in the local network services competitive environment with TCG, AT&T Local, LOGIX Communications and TWTC. I was responsible for the planning, construction and implementation of many of TCG's networks and markets.

3. The purpose of this declaration is to (1) respond to the reply declaration of Parley C. Casto¹ generally; (2) describe how TWTC can only serve Ethernet customers at retail in AT&T's ILEC region if it is able to obtain finished Ethernet services at just and

¹ See Reply Declaration of Parley C. Casto, attached to AT&T, Inc. and BellSouth Corporation Opposition to Petitions to Deny and Reply to Comments, WC Dkt. No. 06-74 (filed June 20, 2006) ("*Casto Declaration*").

REDACTED-FOR PUBLIC INSPECTION

reasonable rates, terms and conditions; and (3) describe why TWTC cannot rely on TDM loops purchased from AT&T along with TWTC-supplied TDM electronics to provide Ethernet Services.

II. TWTC'S BUSINESS AND NETWORK

4. TWTC was established in 1993. It is a leading provider of managed voice and data networking solutions for business customers, carriers, and Internet service providers ("ISPs") in 22 states and 44 metropolitan areas around the country. TWTC provides these services over its own loop and transport transmission facilities wherever possible. However, there are many locations where TWTC is unable to achieve the revenue and return on investment required to deploy its own loop and transport transmission facilities. For example, TWTC serves only 26.8 percent of its customer buildings using its own facilities, while it must rely on other carriers 73.2 percent of the time.² Where TWTC cannot built its own transmission facilities in the BellSouth and AT&T ILEC territories, TWTC must rely almost completely on BellSouth's and AT&T's loops and transport (generally special access services). This is because, in the vast majority of the commercial buildings to which TWTC cannot deploy and has not deployed its own loops in the BellSouth and AT&T ILEC territories, BellSouth and AT&T have respectively deployed their own loops. In fact in TWTC's experience, BellSouth and AT&T own the *only* loops serving most of these commercial buildings in their respective territories.

² See Time Warner Telecom, Inc., SEC Form 10-Q Quarterly Report for the Period Ended Mar. 31, 2006, at 24 (filed May 10, 2006).

III. RESPONSE TO PARLY CASTO'S ALLEGATIONS

5. Mr. Casto makes five general arguments in response to my initial declaration.³ [proprietary begin]

4

6.

See Casto Declaration ¶ 25.

³ See Declaration of Graham Taylor, attached to Petition to Deny of Time Warner Telecom, WC Dkt. No. 06-74 (filed June 5, 2006) ("*Taylor Declaration*").

4

REDACTED-FOR PUBLIC INSPECTION

7.

See Casto

Declaration ¶ 28. [proprietary end] It is true that there are other carriers providing wholesale finished Ethernet services, but these providers generally do not own loop transmission facilities and do not offer wholesale Ethernet in the locations in which TWTC cannot economically self-deploy loops. Notwithstanding TWTC's strong interest in identifying and relying upon wholesale providers of finished Ethernet other than AT&T and other ILECs, TWTC has purchased or is in the process of purchasing [proprietary begin] [proprietary end] finished Ethernet loops at wholesale from non-ILEC wholesalers. Given that TWTC currently serves [proprietary begin] [proprietary end] customer locations with Ethernet services (both on-net and off-net), these [proprietary begin] [proprietary end] loops account for [proprietary begin] [proprietary end] percent of the Ethernet loops TWTC needs to compete. There are a limited number of locations in the AT&T region in which non-ILEC wholesalers offer Ethernet service, and in which TWTC has not purchased Ethernet from these non-ILECs. [proprietary begin]

[proprietary end]

8. It is important to emphasize, however, that in those few places where non-ILECs offer finished Ethernet loops at wholesale, **[proprietary begin]**

⁵ See SWBT Tariff F.C.C. No. 73 § 41.48.4(D)

[proprietary

end]

9. Mr. Casto also argues that because “AT&T has sold very little [sic] OPT-E-MAN services to unaffiliated carrier customers...it shows that the retail market for Ethernet services has developed and is highly competitive even without the availability of OPT-E-MAN as an input.” *Casto Declaration* ¶ 18. Mr. Casto’s reasoning is exactly backwards. TWTC and other carriers have not purchased OPT-E-MAN under AT&T’s federal tariff because AT&T’s high tariffed prices **[proprietary begin]**

[proprietary end] prevent carriers from competing in the downstream Ethernet retail service market. To the extent that TWTC has been able to deploy Ethernet services at retail in AT&T’s region, it has done so using 1) its on-net facilities; 2) TDM loops purchased from AT&T; and 3) an extremely limited number of competitive facilities. As TWTC has only deployed loops to approximately 27 percent of the buildings in which its customers are located, it must rely upon AT&T TDM facilities, which, as I discuss below, are becoming increasingly unviable as a wholesale input for retail Ethernet. As a consequence, TWTC has only been able to serve a small subset of the market that it could otherwise reach if it could obtain finished Ethernet services from AT&T on reasonable terms and conditions.

10. **[proprietary begin]**

REDACTED-FOR PUBLIC INSPECTION

See Casto Declaration ¶

29.

See Taylor Declaration ¶¶ 32, 36-38.

11.

7

⁶ Attached hereto as Exhibit 1.

7

REDACTED-FOR PUBLIC INSPECTION

12.

13.

14.

REDACTED-FOR PUBLIC INSPECTION

15.

16.

[proprietary end]

17. Mr. Casto argues that, even if AT&T's wholesale prices for finished Ethernet are too high to allow TWTC to compete, TWTC can simply purchase AT&T's TDM special access under its 2005 agreement with AT&T and TWTC can supply its own Ethernet electronics. *See Casto Declaration* ¶¶ 19-22. For this reason, Mr. Casto argues that AT&T's finished Ethernet loops are not a necessary input for TWTC's Ethernet services. As I explained in my initial declaration, TWTC does in fact purchase some TDM circuits from AT&T to provide Ethernet services at retail. *See Taylor Declaration* ¶ 43. However, in many situations, Ethernet over AT&T-provided TDM circuits is not a viable option to serve the customer because of the additional costs and inefficiencies involved. I explain these costs and inefficiencies below.

18. *First*, as I explained in my initial declaration, Ethernet over TDM requires the purchase of additional, unneeded electronics. *See Taylor Declaration* ¶¶ 26, 43. When TWTC (or any other CLEC) purchases a TDM loop, that circuit comes with TDM electronics. Although TWTC does not pay a separate charge for these TDM electronics, the fixed cost of these electronics is surely incorporated into the monthly recurring charge

REDACTED-FOR PUBLIC INSPECTION

for the circuit.⁸ TWTC must then place Ethernet customer premises electronics (the “Overture” box) on top of the existing TDM electronics to enable TWTC to offer Ethernet service. The Overture solution adds an additional **[proprietary begin]** **[proprietary end]** in cost per circuit depending upon the configuration and capacity of the circuit. TWTC is therefore essentially paying “double” for the electronics to provide Ethernet over TDM: once for the TDM electronics and once for the Overture equipment to convert the TDM signal to Ethernet.⁹

19. *Second*, in order for TWTC to provide Ethernet over TDM in areas that are not close to the AT&T/TWTC point of interconnection (“the POI”) (which is usually located in a large AT&T central office in a downtown area) TWTC must not only pay for the TDM loop, but also pay substantial mileage charges for transport from the local serving office (“LSO”) in the distant area to the AT&T/TWTC POI. As offered by AT&T under both its month-to-month tariff and its volume discount offers, the transport circuit has both a fixed capacity charge and a substantial variable mileage charge component.¹⁰ **[proprietary begin]**

⁸ As Mr. Casto correctly explains with respect to the cost of Ethernet electronics, when a wholesaler provides finished Ethernet service “it is the wholesale Ethernet provider that purchases and deploys Ethernet electronics, the costs of which are then included in the overall rate for the finished Ethernet access service.” *Casto Declaration* ¶ 21. The same is true of TDM services.

⁹ Mr. Casto asserts that, in my discussion of TDM loops as inputs to Ethernet service, I observed that TWTC must purchase Ethernet electronics when in fact, Mr. Casto asserts all carriers seeking to provide Ethernet service must purchase such electronics. *See id.* But the point is not that TWTC must purchase Ethernet electronics when relying on TDM loops, but that TWTC must purchase *TDM electronics in addition to* Ethernet electronics.

¹⁰ *See* SBWT FCC Tariff No. 73 § 7.3.10 (for DS1s); *id.* § 39.5.2 (for DS3s).

[proprietary end]

20. Ethernet over TDM also increases TWTC's costs because TWTC must purchase much more TDM capacity than it needs to provide the Ethernet service. For example, a DS3 provides approximately 45 Mbps of bandwidth. If a customer demands a 50 Mbps Ethernet loop (a level of service offered by both AT&T and TWTC), TWTC must purchase two DS3s from AT&T. Because of bandwidth loss that occurs when TDM is converted into Ethernet, the customer does not receive 90 Mbps of bandwidth. Rather, assuming a 512 kbps frame (essentially a packet) size, two DS3s only provide 66.5 Mbps of Ethernet bandwidth. Indeed, using Ethernet over TDM results in between a 4 to 30 percent bandwidth loss from the TDM circuit. Under TWTC's pricing flexibility contract with AT&T, two DS3s of capacity costs TWTC \$1,674.12 assuming no interoffice mileage. If there were five interoffice miles, two DS3s would cost an astronomical \$3,024.12 per month ($\$1,674.12 + \900 (fixed interoffice charge) + $(\$90 \times 5)$ (interoffice mileage charge)). **[proprietary begin]**

[proprietary end]

21. If a customer demands a 100 Mbps Ethernet circuit, TWTC must purchase an OC-3 circuit (155.52 Mbps) which will only provide 146 Mbps per second of actual throughput given a 512 kbps frame. This is because three DS3s are generally not suitable to provision a 100 Mbps Ethernet circuit since, assuming a 512 kbps frame, three

REDACTED-FOR PUBLIC INSPECTION

DS3s actually provides less than 100 Mbps of Ethernet bandwidth. An OC-3 circuit under the current AT&T/TWTC discount contract costs \$1670 assuming no interoffice mileage. If there were five interoffice miles, an OC-3 would cost \$3,656 ($\$1670 + \886 (fixed interoffice charge) + $(\$220 \times 5)$ (interoffice mileage charge)). **[proprietary begin]**

[proprietary end]

22. The inefficiencies are highest at the lowest (10 Mbps) Ethernet capacity. A single 45 Mbps DS3 circuit costs \$836.06 per month under the AT&T/TWTC contract assuming no interoffice mileage. If there were five interoffice miles, the cost would be \$1512 per month ($\$837 + \450 (fixed interoffice charge) + $(\$45 \times 5)$ (interoffice mileage charge)) under AT&T's contract tariff. **[proprietary begin]**

23.

[proprietary end]

24. *Fourth*, reliance on TDM loops introduces additional points of potential failure into the circuit. Moreover, identifying the source of service problems is slower,

REDACTED-FOR PUBLIC INSPECTION

more complex and likely more costly when TWTC must rely on two sets of equipment rather than one. If there is a problem with service quality and a circuit provisioned with both TDM and Ethernet electronics goes down, TWTC must send its technicians to the site and AT&T must also send its technicians to the site to determine whether the failure was caused by TWTC's equipment, AT&T's equipment, AT&T's circuit, or some combination of these. Because these locations are often far from the areas where TWTC has built a substantial portion of its network facilities, maintenance calls can take several hours, adding substantial cost and delay to restoring the customer's service. Indeed, unlike AT&T, TWTC only has a handful of technicians in each metropolitan area that it serves, and trouble on multiple distant circuits forces TWTC to hire more technicians. By contrast, if TWTC purchases a finished Ethernet loop, as Mr. Casto explains, only AT&T has the responsibility for visiting the customer site if the service goes down. *See Casto Declaration* ¶ 12. In addition, where TWTC self-deploys its own Ethernet loops, service repair and maintenance truck-rolls are generally much less costly in terms of labor and time because TWTC can only deploy loop facilities close to its existing network, decreasing the distance that must be traveled by the techs and increasing their utilization.

25. As a result of these additional costs and inefficiencies, TWTC can only serve a small subset of the market when relying on TDM transmission inputs than it could otherwise serve if it could obtain finished Ethernet loops on reasonable terms and conditions. **[proprietary begin]**

[proprietary end]

REDACTED-FOR PUBLIC INSPECTION

26. Mr. Casto also misconstrues or is non-responsive to several of the points I made in my initial declaration. **[proprietary begin]**

See Taylor Declaration ¶ 35.

See Casto

Declaration ¶ 33.

11

27.

See Casto

11

Taylor Declaration ¶ 35.

REDACTED-FOR PUBLIC INSPECTION

Declaration ¶ 35.

[proprietary end]

28. Mr. Casto points to a joint TWTC/SBC press release in an attempt to show that TWTC willingly and gladly signed their 2005 special access agreement. He notes that TWTC stated at the time that the contract “strengthens Time Warner Telecom’s ability to compete effectively for the nationwide business market.” *Casto Declaration.* ¶

REDACTED-FOR PUBLIC INSPECTION

42 & n.31. It is true that TWTC was able to provide services to more locations under that discount plan than under the extremely high rates that TWTC was forced to buy previously. But this is an obvious point. **[proprietary begin]**

[proprietary end]

29. Mr. Casto is correct that signing the contract was better than not signing the contract, but this says little about whether the terms of that contract are just and reasonable or sufficient to allow TWTC to expand the scope of its service offerings.

[proprietary begin]

See id. ¶ 43.

REDACTED-FOR PUBLIC INSPECTION

[proprietary end] Because of the absence of alternatives to AT&T's ubiquitous network, TWTC has had to agree to unreasonable terms and conditions in order to obtain prices that permit TWTC to use AT&T's facilities in limited cases.

30. **[proprietary begin]**

See Taylor Declaration ¶¶ 39-41.

31.

Casto Declaration ¶

36.

REDACTED-FOR PUBLIC INSPECTION

32.

12

33.

¹² See Tariff F.C.C. No. 1 § 7.5.22 *et seq.*

]

See Taylor Declaration ¶ 38.

13

14

[proprietary end]

34. TWTC also has obtained substantial anecdotal evidence that AT&T is able to undercut TWTC's Ethernet rates even further because it sometimes offers its retail customers the *intrastate* rate for its Ethernet services. Because many states have largely deregulated their special access services, TWTC in many cases has neither the right to obtain these prices nor does it know what these prices are. However, anecdotal evidence

13

14

REDACTED-FOR PUBLIC INSPECTION

indicates that AT&T's intrastate rates are, in many cases, substantially below their interstate rates.

35. [proprietary begin]

See Casto Declaration ¶ 40.

36.

See Taylor Declaration ¶

38.

REDACTED-FOR PUBLIC INSPECTION

37.

See Casto Declaration ¶ 39.

See Taylor Declaration ¶ 34.

[proprietary end]

38. As I explained in my initial declaration, because TWTC *must rely on* ILEC local transmission facilities to reach customer locations to which TWTC cannot

REDACTED-FOR PUBLIC INSPECTION

efficiently deploy its own facilities, TWTC must work with the ILEC to gain class of service and appropriate prioritization of IP packets as they traverse the ILEC's facilities. Otherwise TWTC cannot provide IP VPN service to customers served by AT&T's facilities. *See id.* ¶¶ 29-30. **[proprietary begin]**

39.

Casto Declaration ¶ 38.

40.

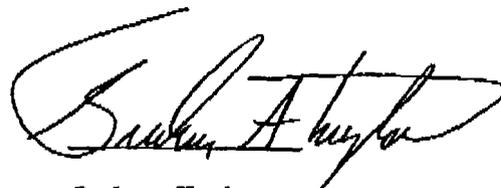
REDACTED-FOR PUBLIC INSPECTION

[proprietary end]

REDACTED-FOR PUBLIC INSPECTION

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on July 25, 2006

A handwritten signature in black ink, appearing to read "Graham Taylor". The signature is fluid and cursive, with a large initial "G" and a long horizontal stroke extending across the middle of the name.

Graham Taylor

REDACTED-FOR PUBLIC INSPECTION

EXHIBIT 1

Charts Redacted in Public Version

REDACTED-FOR PUBLIC INSPECTION

ATTACHMENT B

Declaration of Stan M. Besen and Bridger M. Mitchell

REDACTED-FOR PUBLIC INSPECTION

JOINT DECLARATION

STANLEY M. BESEN AND BRIDGER M. MITCHELL

CRA INTERNATIONAL

JULY 19, 2006

Table of Contents

1.	INTRODUCTION	1
1.1.	Qualifications	1
1.2.	Purpose	2
2.	TIME WARNER TELECOM CONTINUES TO BE DEPENDENT ON ACCESS TO ILEC FACILITIES	5
3.	ILECS HAVE AN INCENTIVE TO ENGAGE IN EXCLUSIONARY BEHAVIOR.....	12
3.1.	Raising Rivals' Costs	12
3.2.	Impairing Rivals' Access	13
4.	THE PROPOSED MERGER WOULD INCREASE AT&T'S AND BELLSOUTH'S INCENTIVES AND ABILITY TO ENGAGE IN EXCLUSIONARY BEHAVIOR	19
4.1.	Out-of-Region Incentives	19
4.2.	Multimarket Effects	21
4.3.	AT&T's Larger Footprint Would Increase Its Incentives and Ability to Engage in Exclusionary Behavior with Respect to Time Warner Telecom.....	25
5.	CARLTON AND SIDER'S MEASURE OF CLEC COMPETITIVE ACTIVITY HAS MANY SHORTCOMINGS	28
6.	BENCHMARKING IS AN ESSENTIAL REGULATORY TOOL.....	32
6.1.	Benchmark Regulation Ameliorates the Information and Incentives Problem	33
6.2.	Forms of Benchmarking.....	35
6.3.	Using Benchmarking to Limit Exclusionary Conduct.....	36
7.	BENCHMARKING IN PRACTICE.....	38
8.	EFFECTS OF MERGERS ON BENCHMARKING.....	43
8.1.	Effects of Mergers on Available Information.....	43
8.2.	Effects of Mergers on the Use of Averages	47
8.3.	Effects of Mergers on Confidence in Performance Benchmarks.....	48
9.	PARITY STANDARDS DO NOT ELIMINATE THE NEED FOR BENCHMARKING	51
10.	INCENTIVE EFFECTS ON BENCHMARKING DUE TO A MERGER	56
10.1.	Unilateral Incentive Effects of Merger under Average-Practice Benchmarking.....	57
10.2.	Unilateral Incentive Effects of Merger under Best-Practice Benchmarking.....	58
10.3.	Coordinated Effects and Risk of Collusion	60

1. Introduction

1.1. *Qualifications*

1. Stanley M. Besen is a Vice President at CRA International, Washington, D.C. Dr. Besen has served as a Brookings Economic Policy Fellow, Office of Telecommunications Policy, Executive Office of the President; Co-director, Network Inquiry Special Staff, Federal Communications Commission; Coeditor, RAND Journal of Economics; and a Senior Economist at the RAND Corporation. He currently serves as a member of the editorial board of Economics of Innovation and New Technology. Dr. Besen has taught at Rice University, where he was the Allyn M. and Gladys R. Cline Professor of Economics and Finance; at Columbia University, where he was the Visiting Henley Professor of Law and Business; and at the Georgetown University Law Center, where he was Visiting Professor of Law and Economics. Dr. Besen has published widely on telecommunications economics and policy, intellectual property, and the economics of standards, and has consulted to many companies in the telecommunications and information industries. He holds a Ph.D. in Economics from Yale University.
2. Bridger M. Mitchell is a Vice President at CRA International, Palo Alto, California. He is an expert in competition and pricing in the telecommunications industry and is the author of five books and numerous articles in professional journals. He has researched regulatory issues involving the theory and practice of telecommunications pricing, competition, and equal access in local telephone markets, interconnection of

REDACTED-FOR PUBLIC INSPECTION

wireless and wireline telecommunications networks, international telephone rates, and broadcasting and cable television. Dr. Mitchell has testified and/or consulted on a number of litigation and regulatory matters involving telecommunications, including market definition, interconnection costing and pricing, incentive regulation, anticompetitive behavior, as well as damages from breach of contract and misappropriation of trade secrets. Prior to joining CRA, he taught economics at Stanford University and UCLA and was a Senior Economist at the RAND Corporation. Dr. Mitchell's international experience includes projects in Argentina, Australia, Brazil, Canada, Hong Kong, India, Malaysia, Mexico, New Zealand, Peru, Thailand, Trinidad and Tobago, the United Kingdom, and the European Union; residence at research centers in Berlin and Delft; and consulting assignments with the World Bank. He holds a Ph.D. in Economics from the Massachusetts Institute of Technology.

1.2. Purpose

3. We have been asked by Time Warner Telecom to assess the effects of the proposed merger of AT&T and BellSouth on the likelihood of exclusionary conduct by these carriers and the resulting ability of other carriers to bring competition to telecommunications service and input markets. In particular, we have been asked to analyze the effect of the increase in the size of the service area (the "footprint") that the merged entity would occupy on its incentives to engage in exclusionary behavior. We have also been asked to analyze the effect of the proposed merger on the ability of telecommunications regulators to employ information about the performance of

REDACTED-FOR PUBLIC INSPECTION

other ILECs (“benchmarking”) in regulating a merged AT&T-BellSouth as well as other ILECs. We conclude that, by increasing the size of AT&T’s footprint, the merger will threaten the entry by, and the expansion of, innovative rivals such as Time Warner Telecom that need access to the facilities of AT&T and BellSouth in order to compete. We also conclude that the merger will make it more difficult for regulators to use benchmark regulation and thus to detect and prevent such exclusionary conduct.¹

4. Because a subscriber to a network benefits from being able to communicate with others, and because of the potential inefficiencies associated with building overlapping facilities, it generally is efficient for carriers to rely on one another’s facilities to exchange traffic between their subscribers. Thus, giving competitors access to the ILECs’ networks generates significant benefits in terms of lower costs and higher quality of service.
5. Access can take several forms. For example, carriers may purchase transport and termination from each other in order to complete calls or exchange data traffic that originates on one network and terminates on another. In addition to negotiating to

¹ We have not been asked to address the effect of the merger on the extent of actual or potential competition between AT&T and BellSouth. However, we cannot resist observing that the merging parties’ claim that they are not direct competitors is completely at odds with the claim, made by SBC when it merged with Ameritech, that the merger would permit it to compete more effectively outside its own service areas, including the service areas served by BellSouth. For example, in his testimony regarding the SBC-Ameritech merger before the Antitrust, Business Rights and Competition Subcommittee, Senate Judiciary Committee, May 19, 1998, Edward E. Whitacre, Jr., Chairman and Chief Executive Officer of SBC stated: “...residential and business consumers in the 30 new markets outside of the companies’ current territory will benefit from the increased competition that will result from our entry into markets....Neither company alone could effectively implement this broad strategy and enter all of these markets in competition with *BellSouth*, Bell Atlantic, USWest, GTE, the large interexchange carriers and CLECs without the companies’ complementary assets and combined strengths.” (emphasis added)

REDACTED-FOR PUBLIC INSPECTION

interconnect their networks, carriers may purchase inputs such as DS1, DS3, or Ethernet loops and transport facilities (collectively “local transmission facilities”) from one another. The purchase of inputs from another carrier can be viewed as a form of access because it allows one carrier to use its own facilities in combination with those of another to deliver services to end users. In what follows, we generally will use the term *access* to include both interconnection and the purchase of inputs.

6. The need for, and value of, access arises whenever multiple carriers provide public services. As a result, the need for access would not disappear even if local competition were vibrant. Moreover, the availability of high-quality, efficiently priced local transmission facilities and interconnection among local networks is a necessary structural prerequisite for local exchange markets to become and remain competitive, especially for carriers like Time Warner Telecom that are bringing advanced services to market and intend to do so in a larger number of geographic areas.
7. If approved, the proposed merger between AT&T and BellSouth would likely increase the merging companies’ incentives and ability to engage in exclusionary behavior by impeding efficient access. AT&T and BellSouth currently possess significant market power in the provision of access services in their respective service regions. This is especially so in the business market because, as the available evidence indicates, AT&T and BellSouth control the only local transmission facilities to the vast majority of commercial office buildings in their respective regions. The resulting market power may be exercised by setting high access prices (in the absence

REDACTED-FOR PUBLIC INSPECTION

of effective price regulation) or by pursuing exclusionary access policies under which AT&T and BellSouth delay, deny, or degrade the access provided to competing carriers.²

8. The proposed merger of AT&T and BellSouth would combine what are today separate and independent local exchange operations and increase the incentives and ability of both companies to disadvantage competitors by reducing the provision of the high-quality, efficient, and innovative forms of access that those competitors require to compete. Moreover, the proposed merger would make it more difficult for state and federal policy makers to use benchmarking to prevent the merged AT&T-BellSouth, as well as other ILECs, from engaging in exclusionary behavior by refusing to provide efficient, high-quality, and innovative access services at reasonable prices to their competitors.

2. Time Warner Telecom Continues to be Dependent on Access to ILEC Facilities

9. AT&T and BellSouth currently possess substantial market power in the provision of access services in both downstream and upstream markets. Downstream markets include those for local exchange services, interexchange services, as well as a variety of innovative telecommunications and information service offerings. Upstream markets are those for the provision of access services to carriers that are, in turn, providers of downstream telecommunications services. For example, Time Warner

² Throughout this Declaration, we use the term *exclusionary* to refer to practices that impair the ability of rival firms to compete, even if the practices do not drive the rivals completely from the market. Thus, it includes conduct that impairs rivals' quality, raises rivals' costs, or slows rivals' entry or expansion.

REDACTED-FOR PUBLIC INSPECTION

Telecom participates in downstream markets as a provider of innovative services, including Ethernet, IP virtual private network, and IP voice services, to business and government customers.³ Time Warner Telecom also participates in upstream markets as a buyer of originating and terminating access services and other inputs from ILECs, and also as a provider of transport and termination services to ILECs and other carriers and a provider of local transmission facilities to other carriers.

10. ILECs have market power in the provision of access services in the upstream markets.

This conclusion follows directly from the fact that carriers such as Time Warner Telecom often have no economically feasible alternatives to the use of ILEC facilities (whether through the purchase of special access or of transport and termination inputs) to reach many of their actual or potential subscribers.⁴

11. Examination of the conditions of entry in upstream markets confirms the conclusion that ILECs have significant market power as providers of access services. There are high barriers to entry facing potential entrants into the provision of access services in competition with the ILECs. First, telecommunications markets are characterized by strong network effects. Thus, any CLEC seeking to offer public telecommunications services must itself interconnect with ILEC local exchange networks to be

³ See Petition to Deny of Time Warner Telecom In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, Federal Communications Commission, WC Docket No. 06-74, June 5, 2006, [hereafter "Petition to Deny"], p. 2. For a more complete description of these services see Declaration of Graham Taylor on Behalf of Time Warner Telecom, Inc., In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control , Federal Communications Commission, WC Docket No. 06-74, June 5, 2006, [hereafter "Taylor Declaration"], ¶¶ 7-16.

⁴ See Reply Declaration of Graham Taylor on Behalf of Time Warner Telecom, Inc., In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, Federal Communications Commission, WC Docket No. 06-74, [hereafter "Taylor Reply Declaration"], ¶ 4 and ¶ 7.

REDACTED-FOR PUBLIC INSPECTION

competitively viable.⁵ The need to interconnect with the ILECs' networks to realize network effects will continue as long as ILECs remain the only way to connect to significant numbers of end users. This need to interconnect with the ILECs' networks gives ILECs the power to limit the threat of entry into their markets by raising entrants' costs, either by raising the price of, or denying, delaying, or degrading, the necessary access.

12. In addition to network effects, there are economies of scale (density) in providing access services. Local network infrastructure has large fixed costs that must be incurred even if a carrier is serving only a small percentage of telephone subscribers in a given area. Thus, small-scale entry is difficult.
13. Finally, an entrant may require inputs from an ILEC to reach locations that are economically infeasible for the entrant to serve. In these cases, the inputs purchased from the ILEC are complements to the entrant's own facilities without which the entrant may not be able to serve a customer at all.⁶
14. Entrants need interconnection with ILECs such as AT&T and BellSouth far more than do AT&T and BellSouth need interconnection with CLECs such as Time Warner Telecom. This is because AT&T and BellSouth serve far more end users than any CLEC. If negotiations over interconnection were to break down, a CLEC would likely

⁵ There is one limited exception. A firm offering solely originating and/or terminating interexchange access could offer service without directly connecting to an ILEC network. That carrier's IXC customers would, however, still need to purchase access from ILECs to reach the vast majority of telecommunications subscribers.

⁶ Taylor Declaration (¶ 6) notes that "the incumbent LEC usually owns the only loop facility serving locations to which TWTC cannot efficiently deploy its own loops. Competitive providers usually have not deployed loop facilities serving such locations."

REDACTED-FOR PUBLIC INSPECTION

be forced out of business as the result of being unable to offer its customers the ability to make calls to, and receive calls from, the ILEC's network. By contrast, not only would the ILEC not be significantly harmed by the lack of interconnection, it would actually benefit from the weakening of competition and the diversion of CLEC customers to its own retail services. Similarly, given the ubiquity of the ILECs' networks, ILECs are far less likely to require access to inputs supplied by an entrant than an entrant is to need access to inputs that the ILEC supplies.

15. The Commission itself has long recognized that ILECs possess substantial market power. Indeed, this recognition is the basis of the Commission's regulation of special access and unbundled network elements.⁷ Moreover, the interconnection provisions of the Telecommunications Act of 1996 also are based on recognition of ILEC market power.⁸

16. In the 10 states in which it operates and in which AT&T or BellSouth is an ILEC, Time Warner Telecom uses its own facilities to provide **[proprietary begin]** **[proprietary end]** of the broadband lines and **[proprietary begin]** **[proprietary end]** of the voice lines equivalents over which it offers service, with the

⁷ Even when the FCC permitted some measure of pricing flexibility for ILEC special access services, it made clear that ILECs remained dominant in the provision of these services and that it would continue to apply dominant carrier regulation to them. See *Access Charge Reform et al.*, Fifth Report and Order, 14 FCC Rcd 14221 ¶ 151 (1999). Similarly, the FCC found that "competitive deployment of stand-alone DS1-capacity loops is rarely if ever economic" and that "competitive deployment of DS3 loops is in some cases economic." See *Unbundled Access to Network Elements et al.*, Order on Remand 20 FCC Rcd 2533 ¶ 166 (2005). The Commission concluded that CLECs must often, if not always, rely on ILECs for these facilities.

⁸ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§ 151 et. seq.

remainder being supplied by the ILEC.⁹ Moreover, these statistics understate Time Warner Telecom's reliance on ILEC local transmission facilities because Time Warner Telecom deploys its own loop facilities to serve only those customer locations with large demands for broadband or voice service. Most customer locations lack sufficient demand to permit Time Warner Telecom to construct its own loops. Nationwide, Time Warner Telecom relies on ILEC loops to serve approximately 73% of the building locations of its customers.¹⁰ These figures clearly indicate that, despite substantial investments in its own facilities,¹¹ Time Warner Telecom still remains heavily dependent on access to AT&T and BellSouth to serve its customer base.

17. Innovative carriers like Time Warner Telecom are particularly vulnerable to exclusionary access policies by ILECs because they need the timely availability of access services from the ILECs for which adequate regulatory safeguards do not exist. Time Warner Telecom relies on dedicated access to reach large customers and there are a variety of ways in which an ILEC can delay providing access,¹² can provide inferior access, or can provide access at excessive prices.

⁹ Based on December 2005 data filed in Time Warner Telecom's March 2006 Local Competition and Broadband Report (Form 477). Taylor Declaration (¶ 9) notes that "Wherever possible, TWTC customers connect directly using TWTC's own local fiber transmission facilities to TWTC's national IP backbone."

¹⁰ See Taylor Reply Declaration, ¶ 4.

¹¹ Taylor Declaration (¶ 4) reports that Time Warner Telecom has installed 72 switches, has deployed nearly 21,000 route miles of fiber, including more than 13,000 route miles deployed in local metro networks, and has invested more than \$2.5 billion in its network.

¹² Annabel Z. Dodd, *The Essential Guide to Telecommunications*, Fourth Edition, Upper Saddle River, NJ: Prentice Hall, 2005 (p. 131) provides an interesting example in which SBC IP asked the FCC for a waiver of the requirement that it obtain telephone numbers from other carriers when it provided service in their areas, presumably because of the costs and delays involved in doing so. Ironically, AT&T objected to

REDACTED-FOR PUBLIC INSPECTION

18. In its Petition to Deny in this proceeding, Time Warner Telecom identifies three areas in which AT&T has delayed the provision of access, has provided inferior access, or has provided access at excessive prices, and where Time Warner Telecom expects these difficulties to be exacerbated if the AT&T-BellSouth merger is approved without conditions. These areas are: (a) DS1 and DS3 local transmission facilities; (b) interconnection and the exchange of both circuit switched and IP-based traffic; and (c) Ethernet local transmission facilities.¹³ Moreover, in its Petition, Time Warner Telecom explains why these problems are likely to be especially severe, and thus more difficult for regulators to address, as it attempts to obtain the types of facilities that it will increasingly need in order to offer innovative IP-based services.¹⁴
19. For example, Time Warner Telecom explains that AT&T has insisted, as a condition of providing special access at a discount from its high month-to-month rates, that Time Warner Telecom make a volume commitment and incur large penalties if it fails to meet the commitment.¹⁵ [proprietary begin]

SBC's request "saying this would be unfair to other VoIP providers." The FCC, in approving SBC's waiver request on a trial basis, noted that allowing SBC to avoid the need to obtain numbers from other ILECs could "foster innovation, speed the delivery of advanced services and allow carriers the opportunity to predict operational difficulties that may arise when a new network technology is deployed on a larger scale." [FCC, Order In the Matter of Administration of the North American Numbering Plan, CC Docket 99-200, Adopted: June 16, 2004, ¶ 4.]

¹³ See Petition to Deny, pp. 34-42, and Taylor Declaration, ¶¶ 32-43, for more details on the problems faced by Time Warner Telecom in attempting to obtain needed inputs from ILECs and Taylor Reply Declaration, ¶¶ 11-15 for details on why [proprietary begin]

[proprietary

end]

¹⁴ Taylor Declaration, ¶¶ 15-16 and ¶¶ 28-30, describes the importance of quality of service commitments to telecommunications customers.

¹⁵ Petition to Deny, p. 15. AT&T argues that claims concerning discrimination in the provision of special access "must be raised in [the Commission's ongoing review of special access pricing and provisioning], not in this merger." (Joint Opposition, p. 92) This misses the point. It is appropriate to consider the effect

¹⁶ [proprietary end]

20. With respect to access to Ethernet loops, Time Warner Telecom explains that
[proprietary begin]

17

¹⁸ [proprietary end]

21. As we explain below, in its current service area AT&T would have incentives to raise prices for Ethernet loops, to expand the use of other types of exclusionary behavior, and to undertake new types of exclusionary behavior, if it were to merge with BellSouth. Similarly, the merged company would have incentives to engage in the same behavior in what is now BellSouth's territory.

of the merger on the availability of services to Time Warner Telecom and other CLECs because the merger will, by increasing the size of the footprint served by the merged entity, increase the incentive of AT&T and BellSouth to engage in discrimination in the provision of special access and, by reducing the number of benchmarks that can be used by regulators, make it more difficult to prevent such discrimination.

¹⁶ [Taylor Reply Declaration, ¶ 7.]

¹⁷ [Petition to Deny, p. 46, and Taylor Declaration, ¶ 41.]

¹⁸ [Petition to Deny, p. 47, and Taylor Declaration, ¶ 39.]

3. ILECs Have an Incentive to Engage in Exclusionary Behavior

22. Even in the absence of their proposed merger, both AT&T and BellSouth today have incentives to engage in exclusionary behavior in the provision of access services. The remainder of this section briefly examines these incentives in the absence of the proposed merger. In the next section, we explain why the proposed merger would increase these incentives.

23. Even if it did not compete downstream with other carriers, an ILEC would have incentives to exercise market power in the sale of access services. However, an ILEC has additional incentives to raise the price of, and to deny, delay or degrade the provision of, access in order to disadvantage the CLECs with which it competes in downstream markets. By denying efficient access to their rivals, ILECs such as AT&T and BellSouth are able to sustain their market power in downstream markets.

3.1. Raising Rivals' Costs

24. Rivals may be disadvantaged by both price and non-price means. One way in which an ILEC can disadvantage a rival is to increase charges for access. A firm generally benefits from an increase in its rivals' marginal costs because such cost increases raise the rivals' profit-maximizing prices and reduce their profit-maximizing output levels at current prices. Raising the costs faced by *potential* rivals may also delay or deter their entry. By charging its competitors more for local transmission facilities and for other needed access services, an ILEC can drive up the retail prices of these competitors, to its own benefit and to the detriment of consumers.

25. Moreover, by disadvantaging carriers, such as Time Warner Telecom, that also offer access services, an ILEC can also maintain its upstream market power in the provision of access services. This provides an additional reason for an ILEC to have incentives to charge wholesale access prices higher than the prices that would be set by an unintegrated monopolist of access services.¹⁹

3.2. Impairing Rivals' Access

26. A second general method of disadvantaging rivals is by denying, delaying, or degrading the provision of the access needed to support the services these competitors provide to their customers. As discussed above, there are many ways in which an ILEC can disadvantage its rivals through its control of essential access services and facilities. For example, consider a carrier that wishes to offer an innovative service in competition with an ILEC. Suppose, however, that this entrant can offer the service efficiently only if it obtains a particular type of access arrangement from the ILEC. The ILEC's refusal to provide that access in a timely fashion can raise the entrant's costs or reduce the quality of its service offerings, thus limiting its ability to compete. In the extreme, the ILEC can destroy the entrant's ability to compete altogether. In either case, the ILEC will earn greater profits.

27. To the extent that regulators succeed in limiting the *prices* of access services, an ILEC will have an increased incentive to employ *non-price* means to raise rivals'

¹⁹ It does not automatically follow that any vertically integrated firm will want to disadvantage its customers in order to promote its own downstream division. The integrated firm must balance the foregone profits from lost upstream sales against the increased profits of its downstream division. Under some conditions, it will not be profitable to elevate the input price charged to downstream rivals.

REDACTED-FOR PUBLIC INSPECTION

costs.²⁰ The threat of non-price exclusionary conduct is particularly great against those entrants that require innovative access arrangements—arrangements that are the most difficult for regulators to monitor effectively. This type of exclusionary behavior is very difficult for policy makers to monitor, and we believe that it is impossible for policy makers fully to prevent.

28. A new entrant trying to roll out its services rapidly on a nationwide basis is especially vulnerable to ILECs' actions that delay or degrade its ability to offer the service. This is so for two basic reasons. First, the harm that the entrant experiences in one geographic area will affect its ability to compete in other areas by denying it the ability fully to exploit economies of scale and scope. Second, lowering the quality and/or raising the cost of the service that an entrant can provide in one geographic area will reduce its attractiveness to customers located in that and other areas if those customers wish to use a single carrier to serve their telecommunications needs.²¹

29. By engaging in non-price exclusionary conduct, AT&T and BellSouth sacrifice profits from the sale of wholesale access in return for increased power in downstream markets. The carriers also run the risk of incurring regulatory sanctions in the event

²⁰ If access and interconnection prices were completely unregulated, the ILEC might not have the incentive to use non-price means of exclusion. This follows from the fact that increasing the price of access generates increased revenue in the upstream market at the same time that it disadvantages rivals in the downstream market. Note that in situations where price discrimination is infeasible but non-price discrimination is not, the ILEC may have the incentive to use non-price means of exclusion even when interconnection fees are unregulated.

²¹ Taylor Declaration (¶ 25) notes that "...it is becoming increasingly important that TWTC serve a higher percentage of its Customer Locations than it has in the past....customers increasingly demand that carriers perform [the] network integration function and that carriers provide all of the services that a business customer needs to all of the customer's locations." See also Petition to Deny, p. 48. We note, again, that SBC claimed that its merger with Ameritech would make it a more effective competitor for customers with facilities in a number of different regions.

REDACTED-FOR PUBLIC INSPECTION

that regulators are able to detect and punish this exclusionary conduct.²² To choose the degree to which to carry out such exclusionary conduct, an ILEC must balance the benefits of exclusion against these costs. In part, the benefits depend on the way in which the ILEC exercises the increased market power that results from exclusionary conduct.

30. In what Katz and Salop call the *relative-margin incentive*,²³ an ILEC enjoys increased retail unit sales at current prices if competition is weakened. Excluding its rivals permits the ILEC to replace upstream sales of *access* services to competitors with downstream sales at *retail* to end users.²⁴ If the incremental retail business that is gained is more profitable than the incremental access business that is lost, and if it is difficult for regulators to detect the exclusionary conduct, the ILEC would have incentives to exclude its rivals.

31. In what Katz and Salop call the *increased-price incentive*, an ILEC exercises the increased market power that results from its exclusionary conduct by obtaining a higher downstream price than would occur otherwise. Although, as in the case of the relative-margin incentive, exclusion of rivals reduces the ILEC's profits from the sale of access services, here the ILEC gains through increasing the price it can charge

²² As discussed below, the ability of regulators to detect exclusionary behavior is limited. However, the greater the extent of exclusionary conduct, the more likely it is that the ILEC will be caught and punished.

²³ For more details see Declaration of Dr. Michael L. Katz and Dr. Steven C. Salop, "Using a Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998, filed on behalf of Sprint Corporation In the Matter of the Application for Consent of to the Transfer of Control of Licenses and Section 214 Authorization from Ameritech Corporation to SBC Communications, Inc.

²⁴ This condition is sufficient, but not necessary. Even if this scenario is not profitable at current prices, it nonetheless may be profitable to exclude a rival if AT&T increases its retail price somewhat instead of increasing its output by the full amount of the reduction in its rivals' output. For regulated services facing new competition, preventing price from falling is treated as a price increase.

REDACTED-FOR PUBLIC INSPECTION

downstream customers because its rivals have been weakened, even if the ILEC's output is unchanged.

32. Even if regulators capped retail prices at levels that make the *relative-margin incentive* negative, the *increased-price incentive* may still exist. Indeed, this incentive may exist even when regulators prevent the ILEC from raising retail prices because exclusionary access policies that raise or maintain barriers to entry and expansion permit the ILEC profitably to *maintain* the current (regulated) downstream price rather than *reducing* the price to meet the threat or actuality of new competition. Deterring a price decrease is, of course, an exercise of market power.
33. Competing telecommunications providers obviously are harmed when an ILEC has significant market power and exercises that power by setting inefficiently high access prices or by denying, delaying, or degrading access below the efficient level. Beyond this harm to competitors, the incentives of CLECs to invest in R&D and physical infrastructure needed to provide these competitive services are reduced. Moreover, the costs of retail services will be increased, which can be expected to raise the retail prices paid by consumers, thus reducing consumer welfare below efficient levels.
34. In light of the welfare-reducing effects of exclusionary conduct, there is a public interest in limiting such behavior. This is, however, very difficult for regulators to do for two fundamental reasons. First, regulation can only imperfectly detect and prevent such conduct, particularly for new and innovative forms of access. Second, the potential for continued consolidation of the large ILECs will further reduce policy makers' ability to exercise effective oversight.

REDACTED-FOR PUBLIC INSPECTION

35. AT&T and BellSouth have claimed that, even if there were problems with the potential exercise of market power, regulatory oversight could sufficiently handle any potential problems.²⁵ We believe that this is not the case even for the provision of “plain vanilla” access, where policy makers have built up experience over a number of years in detecting and addressing problems and where the development of performance standards has been facilitated by the ability to employ regulatory benchmarking, whereby the performance of one ILEC is judged in comparison with the performance of others. It is certainly not the case for access that is needed to support new services.
36. Both market participants and regulators have little experience with how arrangements for new services will work under commercial conditions. Moreover, as entrants launch new services, they will need a variety of innovative access arrangements. For these arrangements, policy makers do not have the benefit of long experience in detecting and correcting problems nor have they had the time to develop comprehensive performance standards. Further, in such cases, the information needed to regulate ILEC behavior may be extremely difficult to obtain. How, for

²⁵ See, for example, Merger of AT&T and BellSouth, Description of Transaction, Public Interest Showing and Related Demonstration, filed with the Federal Communications Commission, March 31, 2006, at 118. (“There is no longer any basis for concerns that [ILEC] discrimination would be difficult to detect. Sections 251 and 271 are now ‘fully implemented,’ and regulators and the industry have many years of experience with those arrangements. Further, as a result of the section 251 and section 271 proceedings, BellSouth and AT&T are subject to comprehensive ‘performance standards’ and self-executing remedy plans that ensure continued compliance with section 251 in all of their incumbent states.”). See also Merger of SBC Communications Inc. and Ameritech Corporation: Description of the Transaction, Public Interest Showing and Related Demonstrations, filed with the Federal Communications Commission, July 24, 1998, at 90-91. “Within SBC’s or Ameritech’s regions, the merger will not in any way alter or diminish the ability of others to compete in local exchange markets. Neither competitors, state commissions nor this Commission will allow any backsliding in the market-opening process.”

REDACTED-FOR PUBLIC INSPECTION

example, would the regulators determine that an ILEC was leaving unused (or underused) equipment in a central office in order to block CLEC collocation? And what sort of rules should govern whether ILECs should be required to provide tag stacking or to comply with class of service and quality of service requirements for IP traffic? In addition, as discussed in more detail below, the merger will make benchmarking more difficult by reducing the number of ILECs and distorting their incentives. For all of these reasons, if the merged AT&T-BellSouth refused to provide efficient new access arrangements, or delayed or slowed deployment of those arrangements, or reduced the quality of access below the efficient level, regulators would face significant difficulties in detecting these distortions and inducing the merged entity to correct its misbehavior.

37. Exclusionary behavior by ILECs threatens the introduction of new services by Time Warner Telecom and other carriers. Long, drawn-out litigation and regulatory proceedings will not resolve the issues soon enough to facilitate rapid entry and expansion. This is unfortunate, because such entry would help to bring increased competition to many telecommunications markets. Although policy makers should not give up trying to limit exclusionary conduct through direct oversight, it is important to ensure that competitive market forces can be used wherever possible. It is equally important that market conditions not be allowed to deteriorate in ways that increase the incentive and ability of ILECs to exercise market power.

4. The Proposed Merger Would Increase AT&T's and BellSouth's Incentives and Ability to Engage in Exclusionary Behavior

38. In light of the strong network effects and the ILECs' dominant position as providers of access services, the provision of access services by ILECs to other carriers under reasonable terms is essential to the ability of rivals to compete effectively. Although AT&T and BellSouth already have incentives to raise their rivals' costs in order to achieve, maintain, or enhance market power in the provision of local exchange and other services, their proposed merger would increase these incentives.
39. The basic logic underlying this anticompetitive effect of the proposed merger is straightforward. In many instances, rival carriers require access from multiple ILECs in order to compete efficiently. The merger of two ILECs increases their incentives and ability to foreclose competing carriers from access to their networks because it allows each of the ILECs to capture the anticompetitive benefits that spill over to the other.

4.1. Out-of-Region Incentives

40. When a competing carrier's ability to serve customers depends upon its ability to obtain efficient access arrangements at reasonable prices from multiple ILECs, the degradation, delay, or denial of access in one ILEC's region may weaken the competing carrier in the region of other ILECs. Because of these multi-market effects, one ILEC's exclusion of competitors from efficient access will anticompetitively benefit other ILECs. Thus, for example, BellSouth may currently

REDACTED-FOR PUBLIC INSPECTION

derive a benefit from AT&T's anticompetitive conduct. Although before the merger AT&T would have little or no incentive to take into account that benefit to BellSouth, after the merger that incentive would be significant.²⁶ Because what had previously been spillover benefits to BellSouth would then be internal to AT&T, after the merger AT&T's incentives to engage in exclusionary behavior would be increased.

Similarly, the merger would increase the merged entity's incentives to engage in exclusionary behavior in what is currently BellSouth's region.

41. This analysis predicts that the merger of AT&T and BellSouth would lead the merged entity to search for new methods to exclude competitors and to intensify its exclusionary conduct. This may mean more significant denials of access in both the AT&T and BellSouth service areas, further delays in granting access, and ultimately lower quality access than would have been provided in the absence of the merger. The fact that AT&T and BellSouth may today have incentives to exclude competitors does not alter this conclusion. Worsened incentives will mean more exclusion as each part of the merged firm is willing to accept a greater risk of regulatory sanctions in return for the increased rewards from successful exclusion.²⁷

²⁶ We understand that AT&T currently has facilities in BellSouth's service area and so would benefit in that area if AT&T's exclusionary behavior in its own service area adversely affected the ability of Time Warner Telecom and other CLECs to compete in BellSouth's service area. However, as AT&T notes, its facilities in BellSouth's service area are limited, so this effect is likely to be very small.

²⁷ In principle, the increased benefits from greater exclusionary behavior could be offset by increased regulatory sanctions in the event that exclusion is detected. However, state regulators in (say) Texas are unlikely to bring sanctions against AT&T for exclusionary conduct towards CLECs in (say) Florida or Georgia. Nor has the Commission shown any inclination to increase regulatory sanctions in response to previous mergers. Moreover, even if this scenario were plausible, there are offsetting effects. In particular, AT&T may have economies of scope in defending itself from such charges in multiple state proceedings. And, even if there is a chance of sanctioning AT&T, disadvantaged entrants may not be willing to wait around for the outcome of the proceedings. In any case, the whole point of encouraging CLEC entry is to

REDACTED-FOR PUBLIC INSPECTION

42. As a result of this increase in exclusionary conduct, rival carriers will be injured and will become less formidable competitors to the ILECs than they otherwise would have been. Consumers also will be harmed as competition is weakened. Prices likely will be higher, service qualities lower, and choices more limited, leading to reduced consumer welfare. To the extent that the disadvantaged competitors would offer differentiated products, or would have lower costs or higher service quality than the ILECs, the harm to consumers will be further magnified.
43. Even if exclusionary conduct in one market does not deter the entry of CLECs altogether, it may lead the CLECs to enter with higher prices or reduced service offerings and/or at lower scale. In any event, the CLECs will be less of a competitive threat to the merged ILECs.

4.2. Multimarket Effects

44. There are basically two ways in which multimarket effects can occur. First, when an ILEC engages in exclusionary behavior in its own region, it may *raise the costs* that Time Warner Telecom and other CLECs incur in other regions. If, for example, Time Warner Telecom enjoy economies of scale and AT&T engages in exclusionary behavior in supplying access to Time Warner Telecom, AT&T's actions will weaken Time Warner Telecom's ability to offer services in BellSouth's region as well.
45. Second, an ILEC's exclusionary behavior may *reduce the demand* for the services of Time Warner Telecom and other CLECs. This can occur, for example, if some

reduce the need for regulation over time; it is not to expand the need for regulation by permitting mergers that enhance the ILECs' incentives to exclude.

REDACTED-FOR PUBLIC INSPECTION

customers have locations in more than one region but wish to obtain all, or a large portion of, their telecommunications services from a single supplier. Here, if AT&T were to reduce the quality of service that Time Warner Telecom can provide in AT&T's region, Time Warner Telecom will become less competitive in serving customers with locations in both the AT&T and BellSouth regions, thus providing benefits to BellSouth as well.

46. Even if multiple local markets are geographically distinct, CLECs such as Time Warner Telecom will incur common research, product development, supporting software development, and promotional costs. In deciding whether to enter specific local markets, Time Warner Telecom will evaluate its overall expected profits from entry. Thus, it would take the sum of its expected market-specific profits across all of the areas that it is contemplating entering and compare this sum with the development and other common costs. Entry will be unattractive if the market-specific profits are less than the common cost plus the required return on capital. Thus, an ILEC's actions that reduce the profitability of entry in one region can lower the likelihood, or the scale, of entry by Time Warner Telecom in all regions.

47. Exclusionary actions also may reduce the speed with which Time Warner Telecom finds it profitable to enter local markets in an ILEC's region or the extent to which it finds it profitable to make investments that improve its service quality. If the exclusion reduces Time Warner's potential customer base in the first region, this reduces its rate of return on investments. For example, suppose that a contemplated investment in product quality would allow Time Warner Telecom to increase the

REDACTED-FOR PUBLIC INSPECTION

number of subscribers that would be attracted to its service. If its potential customer base is reduced by exclusionary conduct in the first region, then fewer new customers can be obtained and it would earn a lower return on that investment. As a result, the investment may not earn a large enough return to justify undertaking it. In that case, potential new customers in the second region would also be denied the quality improvement, so that Time Warner Telecom would not be able to expand there either. Thus, the ILEC in the second region will gain from the exclusionary conduct of the ILEC in the first region.

48. There also may be economies of scope associated with offering service in multiple local markets that affect variable costs (*e.g.*, reduced costs of obtaining certain types of carrier equipment whose use varies with the number of subscribers or traffic volume). In this case, exclusion that reduces an entrant's volume in one market increases the entrant's variable costs in both that market and the other markets in which it is competing.
49. If, in order to compete effectively, rivals require the inputs from two ILECs that propose to merge, the merger increases both ILECs' incentives to foreclose rivals from interconnection and access to inputs by allowing each to "internalize" the benefit that it provides to the other. A merger overcomes the coordination problem that two independent ILECs would otherwise have. Thus, we would expect that a merger would lead AT&T and BellSouth to attempt a greater degree of exclusion than they would attempt independently before the merger.

REDACTED-FOR PUBLIC INSPECTION

50. The merger of AT&T and BellSouth may also increase their *ability* to engage in exclusionary conduct that raises rivals' costs in three ways. First, regulators will no longer be able to monitor, detect, and prove the existence of exclusionary conduct by AT&T by using BellSouth's conduct as a benchmark, or vice versa. Second, after the merger, AT&T and BellSouth may gain the ability to coordinate and rationalize their exclusionary conduct to make detection and proof more difficult.²⁸ Finally, AT&T may benefit from economies of scope in fighting regulatory battles in a number of different states.²⁹

51. Coupled with the fact that AT&T's and BellSouth's incentives to exclude also increase, the conclusion is clear: A merger between AT&T and BellSouth would increase the magnitude of the exclusionary access problem and thereby harm consumers and competition.

52. Finally, as noted above, there may be "demand side" exclusionary effects. These occur when customers that have operations in regions served by different ILECs wish to obtain their telecommunications services in these regions from a single carrier. To the extent that exclusionary behavior by an ILEC makes it difficult for Time Warner Telecom to offer timely, high-quality service in that ILEC's region, these customers will be less willing to purchase services from Time Warner Telecom. Thus, just as in the case where exclusionary behavior in one region raises Time Warner Telecom's

²⁸ While AT&T and BellSouth emphasize the possible sharing of "best practices" post-merger, they may well share "worst practices" (from a public interest perspective) too.

²⁹ In addition, to the extent that state proceedings do not take place simultaneously, AT&T can gain a reputation among entrants as a firm that excludes rivals, and thereby may deter the entrants from attempting to enter in the first place, or it may slow their entry plans.

costs in another, exclusionary behavior in one region may reduce the demand that Time Warner Telecom faces in another. This produces benefits not only to the excluding ILEC but to other ILECs, as well. What would largely be external benefits to AT&T prior to a merger with BellSouth – reduced demand for the services of Time Warner Telecom in BellSouth’s territory – would be taken into account by AT&T after such a merger.³⁰

4.3. AT&T’s Larger Footprint Would Increase Its Incentives and Ability to Engage in Exclusionary Behavior with Respect to Time Warner Telecom

53. AT&T or BellSouth is the predominant ILEC in 22 of the 44 Metropolitan Statistical Areas (MSAs) in which Time Warner Telecom operates.³¹ The scope of AT&T’s and BellSouth’s ILEC service territories can be illustrated by the percentage of interstate switched access minutes that Time Warner Telecom originates or terminates in the AT&T and BellSouth ILEC territories. In **[proprietary begin]** **[proprietary end]** of these MSAs, Time Warner Telecom originated or terminated **[proprietary begin]** **[proprietary end]** of its interstate access minutes of use in 2005 in either the AT&T or BellSouth service territory. In the **[proprietary begin]** **[proprietary end]** other MSAs where Time Warner Telecom operates and either AT&T or BellSouth is the predominant ILEC, Time Warner Telecom originated or

³⁰ As we noted above, AT&T currently has only a limited presence in BellSouth’s service area, so that most of the benefits from AT&T’s exclusionary behavior in its own service area that spill over into BellSouth’s service area are “external” to AT&T.

³¹ For a complete list of these MSAs see Time Warner Telecom, *2005 Annual Report*, p. 10. AT&T is an ILEC in portions of two other MSAs in which Time Warner Telecom operates, San Luis Obispo and Santa Barbara, where AT&T’s share of Time Warner Telecom access minutes is about **[proprietary begin]** **[proprietary end]**

terminated **[proprietary begin]** **[proprietary end]** of its interstate access minutes of use in the territory of one or the other of these two ILECs.³²

54. Time Warner Telecom has **[proprietary begin]** **[proprietary end]** customers in the AT&T service territory and **[proprietary begin]** **[proprietary end]** customers in the BellSouth service territory. These figures, although substantial, are based only on current subscribers and thus they do not reflect Time Warner Telecom's ability to increase the number of customers that it serves in the future, which is likely to be adversely affected by an AT&T-BellSouth merger.

55. To obtain a rough estimate of how AT&T's merger with BellSouth would affect Time Warner Telecom in the future, we have calculated the increase in the proportion of Time Warner Telecom's *potential* market that would be served post-merger by AT&T.³³ At present, AT&T's footprint covers about **[proprietary begin]** **[proprietary end]** percent of addressable monthly spending in Time Warner Telecom's target buildings, when those buildings are defined as those that have demands for **[proprietary begin]** ³⁴ **[proprietary end]** When MSAs served by BellSouth are added to AT&T's footprint, this figure becomes about **[proprietary begin]** **[proprietary end]** percent, an increase of about

³² These data were provided to us by Time Warner Telecom from its carrier billing system.

³³ See Taylor Declaration, ¶ 23, for a brief description of the methodology used by GeoResults to estimate the potential business telecommunications market in each metropolitan area.

³⁴ This calculation ignores target buildings in San Luis Obispo and Santa Barbara.

REDACTED-FOR PUBLIC INSPECTION

[proprietary begin] [proprietary end] percent. Alternatively, when addressable monthly spending in target buildings is defined as buildings within [proprietary begin] [proprietary end] of Time Warner Telecom's fiber plant, AT&T's current footprint covers about [proprietary begin] [proprietary end] percent of Time Warner Telecom's target market. When MSAs served by BellSouth are added to AT&T's footprint, this figure becomes about [proprietary begin] [proprietary end] percent, an increase of about [proprietary begin] [proprietary end] percent. These increases are likely substantial enough to affect the merged AT&T-BellSouth's incentives in its dealings with Time Warner Telecom and other competitors.

56. Most of Time Warner Telecom's customers have multiple locations.³⁵ Indeed, there are [proprietary begin] [proprietary end] current Time Warner Telecom customers with locations in *both* AT&T and BellSouth territories³⁶ and a [proprietary begin] [proprietary end] of the revenues that Time Warner Telecom obtains in the AT&T and BellSouth territories are derived from these customers.³⁷ The importance of these customers makes Time Warner Telecom especially vulnerable to increased exclusionary behavior by a merged AT&T-BellSouth because these customers are particularly likely to switch to another

³⁵ See Taylor Declaration, ¶ 20.

³⁶ This figure was provided to us by Time Warner Telecom.

³⁷ Petition to Deny, p. 5, reports that the customers that Time Warner Telecom serves in both the AT&T and BellSouth regions currently account for [proprietary begin] [] [proprietary end] percent of its billed revenues across the two regions.

carrier if Time Warner Telecom's costs increase, or the quality of its service declines, in *either* the AT&T or the BellSouth service territory.

57. Significantly, one of the effects of increased exclusionary behavior by AT&T-BellSouth may be to reduce the incentives of carriers such as Time Warner Telecom to invest in their own facilities. As Time Warner Telecom points out in its Petition to Deny:

...the need to provide IP service offerings to all or most of a business customer's locations is making competitors more reliant on ILEC transmission facilities. Even if it is possible for a competitor to construct loops to one or more of a business customer's locations, the competitor will need to obtain ILEC loops to serve the remaining locations. Without access to ILEC inputs, competitors are increasingly unlikely to be able to serve the customer at all and are therefore less likely to construct facilities even to the largest of the customer's locations.³⁸

In economic terms, CLECs are less likely to be willing to invest in their own facilities if they are unable to obtain the complementary inputs that they need from ILECs on reasonable terms.

5. Carlton and Sider's Measure of CLEC Competitive Activity Has Many Shortcomings

58. In conducting its review of the proposed SBC-Ameritech merger, the Commission reviewed evidence introduced by Carlton and Sider concerning whether the larger SBC-Ameritech footprint "will give the merged firm greater incentive to discriminate against downstream rivals."³⁹ According to the Commission, Carlton and Sider

³⁸ Petition to Deny, pp. 19-20.

³⁹ Federal Communications Commission, Memorandum Opinion and Order, 99-279, October 8, 1999 [SBC-Ameritech Order], ¶251.

claimed “that competitive LEC activity in LATAs within the merged RBOCs’ regions, as measured by the number of firms that have been assigned numbering codes, is not lower than competitive LEC activity in other RBOCs’ regions, or lower than it would have been but for the relevant mergers, controlling for differences in population size, population growth, and area.”⁴⁰

59. The Commission found Carlton and Sider’s claims “unpersuasive” for three basic reasons. First, the Commission noted that Carlton and Sider themselves recognized that the fact that a carrier has been assigned a numbering code in a particular area does necessarily mean that the carrier is providing service in that area.⁴¹ Second, the Commission observed that, even if a carrier is providing service, the variable used by Carlton and Sider “provides no indication of the number of customers that each competitive LEC is serving. Therefore, this variable does not adequately reflect the degree to which competitive LEC activity in one region may or may not be affected by incumbent LEC discrimination.”⁴² Finally, the Commission questioned whether the variables used by Carlton and Sider “adequately control for ‘economic and demographic characteristics’”⁴³ that differ across regions.

60. In their Declaration in this proceeding, Carlton and Sider note that the Commission had not accepted the conclusions of their earlier analysis. Nevertheless, they state that they “continue to hold the views that our analysis was reliable and that the

⁴⁰ Ibid.

⁴¹ Ibid. ¶ 252.

⁴² Ibid.

⁴³ Ibid.

REDACTED-FOR PUBLIC INSPECTION

available empirical evidence is inconsistent with the footprint theory.”⁴⁴ As justification for this claim, Carlton and Sider note that “a number of other researchers, including both academics and FCC staff members, have relied on the same measure of CLEC activity in several peer-reviewed studies of CLEC entry and have endorsed its use for such purposes.”⁴⁵

61. We have examined what each of the studies cited by Carlton and Sider states about the variable -- carrier numbering codes held by CLECs -- used to measure CLEC activity. Each study takes care to discuss the significant shortcomings of this variable. The following statements are taken from these studies:

Although data on the actual number of CLECs in operation does not exist, the FCC monitors the number of CLECs holding numbers by state and LATA. Although not a perfect measure of competitive entry, this measure represents the closest one can come given the data resources currently available.⁴⁶

An alternative measure of entry in local telephone markets might be the number of lines held by CLECs. However, our market-level analysis precludes using this measure since it is only recorded at the state, rather than the LATA, level.⁴⁷

Data on the number of CLECs in operation do not exist; however, the FCC records the number of CLECs that hold numbers by state and LATA. Although not a perfect measure of firm entry or fringe size, this measure

⁴⁴ Declaration of Dennis W. Carlton and Hal S. Sider, March 29, 2006, ¶ 125.

⁴⁵ *Ibid.*

⁴⁶ J.R. Abel and M.E. Clements, “Entry under Asymmetric Regulation,” *Review of Industrial Organization*, 19, 227-242, 2001, p. 232.

⁴⁷ *Ibid.* footnote 6, pp. 232-233.

REDACTED-FOR PUBLIC INSPECTION

represents the closest one can come given the data resources currently available.⁴⁸

Following passage of the 1996 Act, information reporting requirements imposed on new providers of local telephone service by state and federal regulators were kept to a minimum. What limited information was collected largely received proprietary treatment. While many new providers report local service levels to share holders and stock analysts, these reports are not comprehensive, systematic, or detailed enough to allow one to address the questions examined here. Therefore, we have employed the number of new carriers with numbering resources as a proxy for the number of new carriers providing local telephone service on their own facilities.

While the counts of carriers holding numbering resources are consistently and systematically collected in the LERG and can be determined at the LATA level, they may not perfectly reflect the number of new carriers providing local telephone service on their own facilities. Carriers may acquire numbering resources prior to providing service. Therefore, counts of new carriers with numbering resources may exceed the number of firms actually providing local telephone services.⁴⁹

...the fact that an entrant has obtained a numbering code does not necessarily imply that it is actually offering service in a particular market and to this extent our entry measure may actually overstate the number of actual entrants.... Ideally, we would like to distinguish among the different types of entrants and size of entry – for examples, facilities-based versus reseller for the former, number of lines that new CLECs control for the latter. However, the

⁴⁸ J.R. Abel, "Entry into Regulated Monopoly Markets: The Development of a Competitive Fringe in the Local Telephone Industry," *Journal of Law and Economics*, 45, 289-316, p. 299.

⁴⁹ J. Zolnierok, J. Eisner, and E. Burton, "An Empirical Examination of Entry Patterns in Local Telephone Markets," *Journal of Regulatory Economics*, 19, 159, 2001, pp. 147-148. In the working paper version of this paper dated August 23, 1999, the authors also stated (p. 7) the following: "Competitors that purchase telephone service from incumbents for resale, and do not rely on their own facilities, may choose to either obtain their own numbering resources for billing purposes or rely on the incumbents' numbering resources. Therefore, counts of new carriers with numbering resources may include some non-facilities based providers."

requisite data for making these types of determination were unavailable during our sample period.⁵⁰

62. Not only do these studies note, as do Carlton and Sider, that the assignment of numbering codes to a carrier does not mean that it is providing service, they also observe that a carrier with its own numbering codes may simply be a reseller. Most important, they all recognize that the measure they employ reflects, at best, the existence, but not the scale, of entry.⁵¹ We conclude that there is no reason for the Commission to change its finding that the results of the Carlton-Sider empirical analysis are “unpersuasive.”

6. Benchmarking is an Essential Regulatory Tool

63. Benchmarking, also known as yardstick competition or relative performance evaluation, is a valuable regulatory tool because it helps telecommunications regulators, customers, and nascent competitors become better informed about an incumbent’s capabilities to cooperate with entrants. In the following sections, we explain how the use of benchmarking can and does work in United States and why the ability to compare the performance or behavior of large ILECs is, therefore, not lightly to be sacrificed.

⁵⁰ D.L. Alexander and R.M. Feinberg, “Entry in Local Telecommunications Markets,” *Review of Industrial Organization*, 25, 107-127, pp. 113-114. Interestingly, the authors point out (p. 123) that their results “suggest that the [1996 Telecommunications Act] did induce entry, but this was limited by strategic non-price behavior by incumbents.”

⁵¹ T. Quast, “An Analysis of the Extent and the Means of Entry into Local Telecommunications Markets,” 2005-07-26, a recent working paper, employs the number of UNE-L and UNE-P lines leased by CLECs from RBOC to measure the extent of CLEC entry. Because this reflects the scale of entry, it is likely to be a better, although still imperfect, measure than that employed by Carlton and Sider and in the articles that they cite.

6.1. Benchmark Regulation Ameliorates the Information and Incentives Problem

64. Regulators generally have much less accurate and complete information about the opportunities and constraints facing the firms that they regulate than do the firms themselves. For example, a regulated firm is likely to be much better informed than its regulators about its economic costs and the extent to which it can reduce those costs if given sufficient incentives. The firm will also be better informed about the quality of service that it can provide and the speed at which it can do so. Most significantly, the firm is likely to be far better informed than its regulators about the opportunities for innovation.

65. Modern economic analysis traces much, if not all, of the problems of efficient regulation to this fundamental information asymmetry. If regulators knew what the firms that they regulate could, and could not, accomplish with efficient effort, they could design incentive systems that simultaneously bring prices close to costs and create appropriate incentives for the regulated firms to perform efficiently.⁵² However, because regulators are imperfectly informed, their efforts to control pricing and performance often create incentives for inefficient behavior. Reducing the regulator's informational disadvantage is, therefore, likely to result in more efficient outcomes. In the case of telecommunications regulation, by applying benchmarking to the behavior of ILECs, regulators are able to achieve some of the

⁵² See, for example, David Sappington and Dennis L. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*, Cambridge, MA: The MIT Press and the AEI Press, 1996, p. 3.

benefits of competition in local services even where it does not actually exist. This is so for two closely related reasons.

66. First, comparisons against the performance of other ILECs provide regulators with more *information*. In the case of price caps, for example, additional information increases a regulator's ability to estimate the actual, but unknown, efficiently-achievable performance of an ILEC. The additional information not only tends to improve the estimate but it also strengthens the regulator's resolve (crucial to achieving the incentive benefits of price caps) not to renegotiate rates if the ILECs profits are unexpectedly high or low. In other cases, comparisons with other ILECs allow the regulator better to determine which practices are technically feasible, to scrutinize unusually poor performance, or even to set the best practice as a standard for all ILECs. In short, the regulator's *information problem* is ameliorated by the availability of relevant benchmarks.
67. Second, if future performance standards that are to be applied to an ILEC are based on industry-wide performance, and if the number of independent firms is reasonably large, an individual ILEC's own behavior will have only a limited effect on the standards against which its performance will be judged. As a result, the incentive of each ILEC to alter its current behavior to affect the standard may be substantially attenuated.⁵³ In short, the significance of the *incentive problem* is

⁵³ Basing the standard against which a firm is judged on its own behavior gives rise to what is known as a "ratchet effect" because a good performance today results in a higher target in the future. If a regulated firm anticipates this effect, it will exert less effort to improve its performance than it would if the standard against which it is judged is independent of its own performance.

reduced if regulators can observe, and take into account, the behavior of a sufficiently large number of comparable firms.

68. For both of these reasons, the Commission and other regulators benefit if they can use benchmarking to increase the amount and quality of information they have about the actual and potential abilities of dominant firms and, in turn, to use that improved information to enhance their ability to regulate these firms. In fact, telecommunications regulators have made effective use of benchmark regulation in the past, and continue to do so.

6.2. Forms of Benchmarking

69. Although there are many ways in which benchmarking may be implemented, it is helpful to consider three categories: the use of *average performance*, the use of *best practices*, and the use of *heightened scrutiny of worst practices*. In average performance benchmarking, the performance of an ILEC can be compared to, and the standard against which it is judged can be based on, the performance of all ILECs. When the number of ILECs is large, the behavior of each individual ILEC has only a small effect on the average performance, thus attenuating the incentive problem that would otherwise exist. As discussed below, regulators have used averages in regulating *rates* for access.

70. Regulators can also judge the performance of all ILECs against that of the best performing ILEC. Best practice benchmarking diffuses superior performance among ILECs by holding all to the same high standards. This is likely to be especially

important where ILECs have differing attitudes toward cooperating with CLECs, perhaps because of differences in competitive circumstances. As discussed below, regulators have used best performance in regulating *conditions* for access.

71. Finally, regulators can require poorly-performing ILECs to improve their performance even if it does not reach the level of best practice. Moreover, the possibility that regulators may discipline ILECs with subpar performance should give ILECs the incentives to improve their performance in the first place. Significantly, in each of these cases, the ability of regulators to make use of these tools depends on the availability of information from a number of other similarly situated ILECs.

6.3. Using Benchmarking to Limit Exclusionary Conduct

72. Especially since the passage of the Telecommunications Act of 1996, the Commission has rightly been concerned to open local exchange and exchange access markets to competition. Because of the special features of those markets, Congress judged that mere removal of legal barriers to entry would be insufficient and, instead, established a regime under which ILECs are required to cooperate with their competitors by providing access on reasonable terms to their local network services and resources. Because it is not in the interests of ILECs to provide these facilities to their competitors, regulators must continue to oversee the rates and other terms at which they do so.

REDACTED-FOR PUBLIC INSPECTION

73. An ILEC's competitors—particularly those wishing to offer innovative services—often require new network services and access arrangements, in particular for interconnection to the local network and collocation of their equipment at the ILEC's facilities. Especially in these cases, the Commission is unlikely to have sufficient independent information about the arrangements that are technically feasible, how particular arrangements affect the quality of service that is provided to rivals, and the costs that ILECs must incur to supply these services. In these cases, there is a real risk that an ILEC may refuse to provide access, engage in delay and slow deployment when compelled to do so, and, finally, to offer services only at degraded quality, or, especially in the case of new services, in an inefficient manner.

74. Fortunately, telecommunications regulators in the United States have been able to use benchmarking to address some of these problems. The Commission, the Department of Justice, and the Courts have all acknowledged and relied upon the ability of regulators to employ benchmarking. The existence of a number of large, independently-managed ILECs provides a range of technical, economic, and operating experience from which the Commission, and other regulators, can draw to assess proposed regulatory actions, establish performance standards, and set parameters in incentive-regulation formulas.

75. As the U.S. Court of Appeals for the District of Columbia Circuit has noted:

[T]he existence of seven [R]BOCs increases the number of benchmarks that can be used by regulators to detect discriminatory pricing. . . . Indeed, federal and state regulators have in fact used such benchmarks in evaluating

compliance with equal access requirements . . . and in comparing installation and maintenance practices for customer premises equipment.⁵⁴

7. Benchmarking in Practice

76. As noted above, average practice benchmarking has been used by regulators primarily in setting rates. For example, in a proceeding involving TELRIC pricing, the California Public Utility Commission recently set SBC's cost of capital by relying on a "proxy group" of similar companies. Although SBC initially proposed that Qwest and Broadwing be included in the proxy group, AT&T and MCI argued that these ILECs should be excluded because "they are much smaller, experiencing major financial difficulties, and investors perceive greater risk from these two companies."⁵⁵ The PUC agreed with AT&T and MCI and excluded both Qwest and Broadwing, leaving only SBC, Verizon, and BellSouth in the proxy group.⁵⁶
77. In establishing the rates that Cincinnati Bell Telephone could charge for interconnection and unbundled network elements, the Ohio Public Utility Commission employed a cost of capital from "proxy groups [that] consist of telecommunications

⁵⁴ *United States v. Western Electric Co.*, 993 F.2d 1572, 1580 (D.C. Cir.), *cert. denied*, 126 L. Ed. 2d 438 (1993).

⁵⁵ See *Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050 et al.*, Opinion Establishing Revised Unbundled Network Element Rates for Pacific Bell Telephone Company DBA SBC California, Application 01-02-024 *et al.*, Decision 04-09-063, 2004 Cal. PUC LEXIS 476, at *220 (Sept. 23, 2004).

⁵⁶ *Ibid.* at *221.

REDACTED-FOR PUBLIC INSPECTION

companies that are the most reasonable comparison of CBT's business ventures."⁵⁷

Similarly, the District of Columbia Public Service Commission concluded: "Of the two options presented for selection of a group of proxy companies, the group of telecommunications companies provides a more appropriate starting point for the purposes of developing UNE rates" for Verizon DC.⁵⁸

78. Best practice benchmarking allows regulators to impose a performance requirement on all regulated firms if that level of performance has been achieved by any comparable regulated firm. An important example of the use of this type of benchmarking occurred when the Commission concluded that interconnection or access at a particular point in one ILEC network is evidence of the technical feasibility of providing the same or similar interconnection in another ILEC network.⁵⁹ Further, the Commission found that successful interconnection at a particular level of quality in one network is substantial evidence of the feasibility of interconnection at the same level of quality in another network. Best practice benchmarking in this regard is now embodied in FCC Rule 51.321 (c), which states:

...a previously successful method of obtaining interconnection or access to unbundled network elements at any particular premises or point on any incumbent LEC's

⁵⁷ Application of Cincinnati Bell Telephone Company for Approval of a Retail Pricing Plan Which May Result in Future Rate Increases and For a New Regulatory Plan, Supplemental Opinion and Order, Case No. 96-899-TP-ALT, 1000 Ohio PUC LEXIS 620 at *36 (November 4, 1999).

⁵⁸ Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996, Opinion and Order, Formal Case No. 962, Order No. 12610, 2002 D.C. PUC LEXIS 421 at *179 (December 6, 2002).

⁵⁹ FCC 96-325, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, adopted August 1, 1996, released August 8, 1996, ¶ 204 (henceforth Local Competition Order).

REDACTED-FOR PUBLIC INSPECTION

network is substantial evidence that such method is technically feasible in the case of substantially similar network premises or points.

79. *Exchanging traffic over a single trunk group.* Relying on this approach, the Indiana Utility Regulatory Commission, observing that BellSouth had voluntarily agreed with Level 3 to exchange all traffic, including interLATA toll and IP Enabled traffic, over a single trunk group, concluded that this “completely justifies” Level 3’s request to receive the same treatment from SBC.⁶⁰ Of course, had SBC and BellSouth been parts of the same company, and had BellSouth adopted SBC’s approach, Level 3 could not have relied on BellSouth’s behavior to obtain the relief that it sought.

80. *Splitter functionality.* Similarly, in a proceeding in 2000 before the Illinois Commerce Commission, Covad was able to rely on the fact that BellSouth had provided splitter functionality on a bulk basis to obtain the same functionality from Ameritech, which was by then part of SBC. In particular, the Commission found that Ameritech “has not provided any convincing evidence that the BellSouth method is technically infeasible in Illinois.”⁶¹ As in the Indiana matter discussed

⁶⁰ In the Matter of Level 3 Communications, LLC’s Petition for Arbitration Pursuant to Section 252 (b) of the Communications Act of 1934, As Amended by the Telecommunications Act of 1996, and the Applicable State Laws for Rates, Terms, and Conditions of Interconnection with Indiana Bell Telephone Company D/B/A SBC Indiana, Cause No. 42663 INT-01, Indiana Utility Regulatory Commission, 2004 Ind. PUC LEXIS 465, at *67 (Dec. 22, 2004).

⁶¹ Covad Communications Company Petition for Arbitration Pursuant to Section 252 (b) of the Communications Act of 1934, As Amended by the Telecommunications Act of 1996 to Establish an Amendment for Line Sharing to the Interconnection Agreement with Illinois Bell Telephone Company d/b/a Ameritech, and for an Expedited Arbitration Award on Certain Core Issues; Rhythms Links, Inc. Petition for Arbitration Pursuant to Section 252 (b) of the Communications Act of 1934, As Amended by the Telecommunications Act of 1996 to Establish an Amendment for Line Sharing to the Interconnection Agreement with Illinois Bell Telephone Company d/b/a Ameritech, and for an Expedited Arbitration

REDACTED-FOR PUBLIC INSPECTION

immediately above, it is likely that the BellSouth benchmark would have been unavailable to Covad had Ameritech and BellSouth been part of the same company.

81. *Dual-purpose line cards.* In a proceeding that demonstrates that either AT&T or BellSouth can be the source of the best practice, Covad requested that the Tennessee Regulatory Utility Commission order BellSouth to install dual-purpose line cards in its Next Generation Digital Loop Carriers. The Commission noted that Covad had argued “although it may be true that BellSouth cannot begin installing NGDLC line cards *today*, it is absolutely clear based on the SBC example that it could begin doing so in the near future.”⁶² The Commission ordered BellSouth to install the technology in Tennessee by the end of a six month waiting period.

82. *Collocation arrangement time.* The Louisiana PUC’s staff found that BellSouth’s allowed total elapsed time to provide collocation to a CLEC would be increased if the time required to obtain a building permit was excluded from the collocation provisioning standards and instead included as a separate and additional time allowance. Noting that neither Bell Atlantic-New York nor Southwestern Bell Telephone excluded permit time from their collocation provisioning standards, and that apparently no other ILEC had proposed such an exclusion, staff recommended

Award on Certain Core Issues, Arbitration Decision, 00-0312 – Consol. 00-0313, 2000 Ill. PUC LEXIS 660, at *36.

⁶² See Generic Docket to Establish UNE Prices for Line Sharing Per FCC 99-355, and Riser Cable and Terminating Wire as Ordered in TRA Docket 98-00123, Order on Petition for Stay and Requests for Reconsideration and Clarification, Dkt. 00-00544, 2002 Tenn. PUC LEXIS 196, at *9 (June 27, 2002).

REDACTED-FOR PUBLIC INSPECTION

that the PUC include permit time in the calculation of average collocation provisioning times, but to allow for a case-by-case waiver process.⁶³

83. *Hot cuts measurement period.* As still another example, AT&T criticized the length of the measurement period used by Southwestern Bell Telephone Company to assess the extent to which competitors were experiencing installation difficulties on lines provisioned by CHC's [coordinated hot cuts] and FDT [frame due time] hot cuts.⁶⁴ In responding to this criticism, SWBT "submitted trouble data for the 7 day period following installation identical to the standard discussed in the *Bell Atlantic New York Order*."⁶⁵ Based on SWBT's submission of data in accordance with the Bell Atlantic benchmark, the Commission was able to conclude that "SWBT installs hot cuts of quality sufficient to provide an efficient competitor with a meaningful opportunity to compete."⁶⁶

84. More generally, telecommunications regulators and antitrust authorities have relied on benchmarking in a wide variety of settings. A previous report by Farrell and

⁶³ Louisiana Performance Metrics Order: *BellSouth Telecommunications, Inc. Service Quality Performance Measurements*, General Order, Docket No. U-22252-(Subdocket-C), 2000 La. PUC Lexis 234, at *20-21.

⁶⁴ Federal Communications Commission, Memorandum Opinion and Order In the Matter of Application by SBC Communications Inc., Southwestern Bell Telephone Company, And Southwestern Bell Communications Services, Inc. d/b/a/ Southwestern Bell Long Distance, Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Texas, CC Docket No. 00-65, Adopted June 30, 2000, ¶ 274.

⁶⁵ *Ibid.* footnote 777.

⁶⁶ *Ibid.* ¶ 274. In its Qwest Colorado et al., 271 Order [*Application by Qwest Communications International, Inc. for Authorization To Provide In-Region, InterLATA Services in the States of Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington and Wyoming*, Memorandum Opinion and Order, 17 FCC Rcd 26303 (2002)], the Commission also relied on benchmarking to approve Qwest's performance. In particular, the Commission found: "Although Qwest's commercial data show low monthly total flow-through rates, Qwest's total flow-through rates are comparable to those of BOCs that the Commission has previously approved." (¶ 110, emphasis added)

Mitchell⁶⁷ recounted the application of benchmarking to: access to OSS functions, open architecture, trunk-side interconnection, cageless collocation, operating expenses, line-of-business restrictions, equal access, overhead costs, collocation, and non-primary lines. In these instances average-practice benchmarks, best-practice benchmarks, and scrutiny of worst-practices were all considered or employed.

8. Effects of Mergers on Benchmarking

85. In this section, we explain why mergers between large ILECs reduce the effectiveness of benchmarking as a regulatory tool. We begin by analyzing the effects of a reduction in the number of separately owned and operated carriers that can serve as benchmarks for evaluating the conduct of other carriers or of the industry as a whole.⁶⁸ We then explain how this reduction worsens the incentives for efficient behavior by the regulated firms.

8.1. Effects of Mergers on Available Information

86. In many cases, after a phase-in period, the merged firm may adopt a common practice in such matters as pricing of services, availability of network components, and provisioning practices. As a result, after the merger, regulators will be able to observe only the behavior of the merged firm where previously it had available two

⁶⁷ See Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998, filed on behalf of Sprint Corporation In the Matter of the Application for Consent of to the Transfer of Control of Licenses and Section 214 Authorization from Ameritech Corporation to SBC Communications, Inc.

⁶⁸ FCC 97-286, ¶ 147.

independent observations. Moreover, even where the merged firm retains somewhat different practices in each of its previously separate entities, it may report information at the firm level, thus providing less information about the range of performance than when the two firms were separate. Finally, even where the merged firm reports separate results for each of its entities, the information can be less useful than the corresponding data it provided when the entities were independent.⁶⁹

87. Consider the following case: Each of n ILECs (prior to a merger) reports a statistic x_i , where $i = 1, \dots, n$. Each x_i is drawn from a distribution with some parameter(s), say b , and thus contains information about b .⁷⁰ The Commission wishes to learn something about b , perhaps in order to set a performance standard. Suppose that the parameter b is equal to 1 if a particular practice has been successfully implemented on at least a trial basis, and is equal to 0 if it is not. For each firm i the observation x_i is, with probability p , equal to b (which may, of course, be 0 or 1), and, with probability $1 - p$, equal to 0.⁷¹

⁶⁹ In this regard, the U.K.'s Monopolies and Mergers Commission (MMC), in considering the potential loss of independent observations through the merger of two water and sewerage companies, found that "the use of sub-company data is very much a second best ... first, that there are major cost allocation difficulties in the use of sub-company data and secondly, ... such data exhibit less variation and are hence less informative than they would be if they reflected the input of independent management." Monopolies and Mergers Commission's discussion of the Director General's comments, in its analysis of the proposed merger of Wessex Water Plc and South West Water Plc: Monopolies and Mergers Commission, *A report on the proposed merger*, October 1996, para. 2.76.

⁷⁰ The analysis is simplest if the x_i are independent and identically distributed, but that is not necessary for the basic insights.

⁷¹ That is, with probability p firm i implements the practice, if it is indeed practicable, and with probability $1-p$ it does not, even if it would be practicable.

REDACTED-FOR PUBLIC INSPECTION

88. In employing best practice regulation, a sufficient statistic for b is the maximum of the x_i . An admissible (and sensible) decision rule is to require the practice to be implemented if and only if that maximum value is 1: this is best-practice benchmarking. If instead of independent reports, only a merged report $x_{1\&2}$ is available, the information on b is undamaged only in the special case where the merged report $x_{1\&2}$ is constructed so as to equal $\max[x_1, x_2]$.

89. However, if the merging firms operated differently prior to the merger, it is as likely as not that the merged firm would implement the particular practice after the merger. In our notation, if (say) $x_1 = 0$ and $x_2 = 1$, then $x_{1\&2}$ is equally likely to be 0 or 1. In that case, observing $x_{1\&2}$ is strictly less informative than observing both x_1 and x_2 .

90. In this case, we can rather easily quantify the loss of useful information from the merger. The key observation is that $x_{1\&2}$ has the same distribution as a single draw x_i . To see this, note that with the “equally likely” aggregation rule, the probability that $x_{1\&2} = 1$, conditional on $b = 1$, is given by $p^2 + 0.5[p(1-p) + (1-p)p] = p$.⁷² Conveniently, in this formulation, from the point of view of best-practice benchmarking, the merged firm is just like one of the original firms: mathematically, the merger then is equivalent (from this point of view) to a simple reduction in the number of observations, n .

⁷² Pre-merger, the probability that at least one of these two firms would reveal the feasibility of the particular practice is $1 - (1 - p)^2$.

REDACTED-FOR PUBLIC INSPECTION

91. For example, if pre-merger $n=4$ and $p=.125$ the probability that the particular practice is successfully implemented by at least one firm is given by $1 - (1 - p)^n$. Substituting for p and n , we see that this probability is 0.41. If two of the four firms merge, the probability falls from 0.41 to $1 - (1 - p)^3 = 0.33$. Note that when the 7 original RBOCs and GTE were independent firms, the probability would have been 0.66. Thus, the series of mergers that began with SBC-PacTel and culminated in SBC-Ameritech and Bell Atlantic-GTE has reduced the calculated probability that at least one firm successfully implemented the practice – so that the Commission can employ it as a best practice standard – from .66 to .41, or by more than a third. An AT&T-BellSouth merger would further reduce the probability by 20 percent – to just half of the value that existed before the series of mergers took place.

92. AT&T's and BellSouth's own comments in this proceeding suggest that there are currently differences in the practices of the two companies. For example, in their Joint Opposition, AT&T and BellSouth state: "To the extent the practices of AT&T and BellSouth *in fact* differ, they reflect different responses to marketplace conditions...."⁷³ If, for example, BellSouth has been more cooperative than has AT&T in its dealings with entrants, our analysis indicates that this difference in "responses to marketplace conditions" would diminish or disappear altogether.

⁷³ Joint Opposition, p. 100, italics in original.

8.2. Effects of Mergers on the Use of Averages

93. Next, consider the reduction in information due to merger as it affects the use of average-practice benchmarking. We develop two points. First, the best point estimate of the underlying parameter b – loosely, an “average” – may in fact depend on more than a simple weighted average of firms’ reports, so that “the average” may be less accurately calculated after a merger. Second, losing information on variation among ILECs may rationally reduce the confidence needed by regulators to use an average measure as a benchmark, and thus may make them more tentative in their use of such averages.
94. Consider the case in which the Commission wishes to use the average cost of all ILECs for providing a given type of access as the benchmark for all ILECs. We can view x_i as firm i ’s performance, and model this performance as the sum of two terms – a “normally achievable” performance b , plus an idiosyncratic “error” e_i with mean zero. Thus, from an information point of view, the Commission is comfortable in applying the average-performance benchmark to firm i to the extent it believes that benchmark is a reasonably good estimate of what firm i is capable of achieving.
95. If the error terms are uncorrelated across firms and their variances are known and proportional to the square of the sizes of the ILECs (where size is measured, say, by number of lines), then an efficient estimate of b is the size-weighted “sample mean” or average of the x_i . In this special case, the estimate of b , and its statistical precision, are unaffected by a merger between firms 1 and 2 even if, following the

merger, costs are reported only at the consolidated level. Intuitively, since the optimal use of all observations x_i was merely to take the weighted average anyway, nothing has been lost if two observations were merged into a “within-group” weighted average value before being reported.

96. However, in the more general case, this result does not hold. For example, some unobserved effects in the error term may be common to several firms in a given year and other unobserved effects may persist for several years for a single firm. Because the covariance structure cannot be taken as known *a priori*, an efficient estimate *will not* use only the weighted mean of the observations x_i .⁷⁴ The Commission’s inferences about b will then be predictably less accurate if it has reliable access only to the weighted mean of x_1 and x_2 rather than to each of these values separately. In other words, a merger impairs the average benchmarking process.

8.3. Effects of Mergers on Confidence in Performance Benchmarks

97. More generally, the Commission often lacks strong *a priori* knowledge of the variance with which the observations x_i are distributed around the unknown parameter b . This is particularly likely in a *sui generis* proceeding as compared with one designed to measure well-established performance, such as recent changes in ILEC productivity. Specifically, consider the standard Bayesian model in which

⁷⁴ For example, the method of generalized least squares estimation first uses the observations x_i to estimate a covariance structure that is then used to construct a more efficient estimate of the unknown parameter b .

the x_i are independent draws from a normal distribution with unknown mean b and unknown standard deviation σ , and in which the prior distribution of b and of $\log(\sigma)$ is the improper uniform.⁷⁵ The observer's point (posterior mean) estimate of b is the average of the x_i . As above, this is unaffected when only average information is reported. Nevertheless, the posterior distribution of b depends on the separate observations x_i . Observing only pre-averaged data increases the posterior *variance* of b , because the observer has less information and thus must be less confident in the estimate of b .

98. For example, suppose we begin with $n=8$. Then the posterior variance is given by⁷⁶ $[(n-1)/(n(n-3))]s^2$, an expression that depends on the sample variance s^2 , but whose prior expectation is equal to $(7/40)\sigma^2$. Now if a series of mergers reduces n to 4, there will be half as many observations, each of which is now normally distributed around the unknown b with (unknown) variance $\sigma^2/2$. The prior expectation of the posterior variance of b is now equal to $(3/4)\sigma^2/2 = (15/40)\sigma^2$. The result of this wave of ILEC mergers is that (in prior expectation) the posterior variance on b more than doubles. As a result, the Commission must be less confident in its estimate of industry performance and be more cautious in establishing any performance standard. Even if the Commission had data about the performance of smaller carriers, the additional loss of information that would result from the

⁷⁵ See, for instance, George G. Judge, R. Carter Hill, William E. Griffiths, Helmut Lütkepohl, and Tsoung-Chao Lee, *Introduction to the Theory and Practice of Econometrics*, 2nd Edition, New York: John Wiley & Sons, 1988, p. 150.

⁷⁶ See Judge et al., p. 152.

REDACTED-FOR PUBLIC INSPECTION

proposed AT&T-BellSouth merger would further increase the variance and reduce the confidence in any benchmark that the Commission might establish.⁷⁷

99. As this conclusion suggests, the Commission often wishes to make a rule but to be reasonably confident that it is not unduly harsh. In many problems, this can be formulated as a desire to set a performance standard y as demanding as possible but such that the probability that y is less than the unknown b is acceptably low. Statistically, this amounts to finding a confidence interval.

100. In most instances, the degree of variability will not be known in advance, and the Commission must generally rely on experience reported by the ILECs to arrive at a suitable confidence interval (in estimation terms) or band of tolerance (in behavioral terms). Thus, the Commission will use the data for more than a point estimate of b .

101. The reduced number of observations of, say, ILEC costs increases the variability of the Commission's cost standard for a zone of reasonableness – the sample mean plus one sample standard deviation. In a framework of Bayesian estimation of a parameter b and its distribution, the reduced number of observations diminishes the Commission's confidence that a mean-plus-one-standard-deviation interval actually covers the range of costs of efficient ILECs.

⁷⁷ Even where the Commission has not relied specifically on benchmarking to establish performance standards, it has used benchmarks to confirm the appropriateness of the standards that it has established, thus increasing its confidence in adopting them. For example, in its Colorado 271 Order, the Commission noted: "We find that the recurring charges in Colorado comply with section 252 (d) (2) on their own merit and not based on a comparison to any other state. *We take comfort, however, in the fact that the rates established by the Colorado Commission are in the range of rates in states that have already received section 271 approval.*" (Qwest Colorado et al., 271 Order, footnote 693, emphasis added.)

102. As the number of ILEC observations is reduced by mergers, the Commission's power to constrain excessive pricing by this kind of benchmarking is weakened and the tools for setting bands of reasonable costs ultimately become ineffective. To make this point most starkly, consider an industry with just two firms, and suppose that the Commission were to attempt to employ the "mean plus one standard deviation" standard to establish a maximum value for a performance measurement. Let the two observations be x_1 and $x_2 \geq x_1$, so that the sample mean is $(x_1 + x_2)/2$, and the sample standard deviation is $\sqrt{2} (x_2 - x_1)/2$. The Commission's zone of reasonableness, which allows everything up to one sample standard deviation above the sample mean, is now so large that even the maximum observation, x_2 , is *certain* to be judged reasonable! In other words, the technique now has no bite whatsoever. The standard would have to be even more lax, if that were imaginable, if the Commission took account of the lower probability that a one-standard-deviation allowance would truly cover sampling variation because of the small number of observations.⁷⁸

9. Parity Standards Do Not Eliminate the Need for Benchmarking

103. In their Joint Opposition, AT&T and BellSouth argue that benchmarking is no longer necessary. We have addressed the first of the reasons given for this

⁷⁸ With $n=2$ and independent normal errors, the classical probability that the sample mean plus 1 sample standard deviation exceeds the population mean is only 0.75. (75% of the standard t distribution with one degree of freedom lies below 1.) To define a zone of reasonableness that would have 90% probability of including the population mean, one would have to allow variability of 3 standard deviations.

REDACTED-FOR PUBLIC INSPECTION

position—that telecommunications markets are so competitive that AT&T and BellSouth have neither the ability nor the incentive to foreclose entrants—above. We now examine the second reason given by AT&T and BellSouth for the diminished importance of benchmarking is that the requirement that is imposed on ILECs—that they treat rivals at least as well as they treat themselves or their affiliates, together with the associated payment of damages if they fail to do so—eliminates their incentive to behave anticompetitively.

104. AT&T and BellSouth argue that “...the relevant comparisons are between the ILEC’s performance in providing service to itself and its performance in providing service to others - *i.e.*, parity standards.”⁷⁹ What this claim fails to recognize is that achieving parity is not the same as cooperating with rivals. This is most obvious in the case where an entrant wishes to provide a retail service that the ILEC does not itself provide. In this case, “parity” would not require any cooperation by the ILEC. In employing the parity standard, the ILEC could either deny the wholesale service to the entrant by refusing to provide the service at retail, or delay offering the wholesale service until it has its own retail offering ready to market. In either case, the entrant would lose the advantage of early entry. Thus, the parity standard is

⁷⁹ Joint Opposition, p. 106. The same claim is made in the Joint Declaration of William L. Dysart, Ronald A. Watkins, and Brett Kissel (henceforth “Dysart Declaration”): “...AT&T complies with the parity requirements of [Section 272 of the Communications Act of 1996] in the provisioning of special access.”(¶5) and “Using these data, both regulators and carriers unaffiliated with AT&T can readily determine whether the timeliness of AT&T’s performance for the seven metrics for nonaffiliates as a whole is at parity with its performance for itself and its affiliates (including the Section 272 affiliate).” (¶ 36)

REDACTED-FOR PUBLIC INSPECTION

least likely to be useful where entrants wish to offer innovative services to their subscribers.⁸⁰

105. The point that parity standards cannot be complete substitutes for benchmarks has often been made by the Commission. For example, in its Kansas/Oklahoma Section 271 Order, the Commission observed: “Where no retail analogue exists to compare SWBT’s performance towards competing carriers to SWBT’s performance to its retail operations, we evaluate SWBT’s showing to ascertain whether SWBT affords competing carriers a meaningful opportunity to compete. As a result, *we sometimes rely on performance measurements that use a benchmark instead of a parity standard.*”⁸¹

106. In their Joint Opposition, AT&T and BellSouth observe that: “Although AT&T hopes to expand this [wholesale Ethernet] service and attract customers like TWTC, AT&T currently sells very little of this relatively new OPT-E-MAN services on a wholesale basis to retail Ethernet providers.”⁸² In this case, regulators must decide whether, in light of the AT&T’s paucity of experience with this service, the limited amount of this wholesale service that AT&T is apparently offering is reasonable, or

⁸⁰ Even where the ILEC offers the wholesale service to itself, the parity standard may fail to protect entrants, notwithstanding compensation the ILEC is required to make to entrants when it provides services that are inferior to those that it provides to itself. The reason is that an entrant that obtains poor wholesale service from an ILEC—say a service that involves long delays in provisioning—will develop a reputation for poor retail service among potential subscribers. In such cases, payments provided to entrants for actual instances of poor performance will fail to compensate them for the profits they would have earned from subscribers that they would have attracted but for their reputation for poor retail service.

⁸¹ *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, Memorandum Opinion and Order, 16 FCC Rcd 6237 (2001), footnote 514, emphasis added.

⁸² Joint Opposition, p. 99.

REDACTED-FOR PUBLIC INSPECTION

whether it is the result of anticompetitive behavior by AT&T -- for example, unreasonably high prices or degraded service -- that is designed to handicap the entry of competing suppliers of retail Ethernet service. In reaching its decision, an extremely useful piece of information for regulators to have would be whether other ILECs are offering the service to CLECs. Significantly, Time Warner Telecom has been able to point out in this proceeding that the terms on which it can obtain access to wholesale Ethernet services **[proprietary begin]**

⁸³ **[proprietary end]**

107. In their Declaration in support of the Joint Opposition, Dysart *et al* argue: "... to the extent that opponents believe that the current performance measurements are 'obsolete', they have the right to seek new or changed measurements to reflect the new developments that they describe."⁸⁴ Although this is, of course, correct, Dysart *et al* fail to note that one of the most persuasive forms of evidence that a CLEC can offer in support of claims that current performance measurements are inadequate would be that other ILECs are achieving higher levels of performance. Thus, it is not correct, as Dysart *et al* claim, that "AT&T's reporting of performance data ... eliminates any need to 'benchmark' its performance against that of other ILECs."⁸⁵ Performance measurements are, at best, a complement to benchmarking, not a substitute for it.

⁸³ Taylor Reply Declaration, ¶ 10 and ¶ 28.

⁸⁴ Dysart Declaration, ¶ 53.

⁸⁵ Dysart Declaration, ¶ 51.

REDACTED-FOR PUBLIC INSPECTION

108. Finally, in their discussion of their negotiations with Time Warner Telecom to develop a contract tariff for Ethernet access service, AT&T and BellSouth inadvertently provide support for the need for benchmarking. They argue: “To be sure, TWTC is seeking even lower prices than AT&T has proposed and features that AT&T’s service does not currently support. But these are exactly the type of issues that should be - and ... can be - resolved at the bargaining table, not in a merger proceeding.”⁸⁶ What this statement fails to note is that an important way in which the Commission, and other regulators, and Time Warner Telecom itself, can judge the reasonableness of AT&T’s behavior, is by comparing it to the behavior of other ILECs. By eliminating an important benchmark the proposed merger of AT&T and BellSouth would seriously diminish their ability to do so.

109. In summary, we have seen how mergers reduce the flow of information for benchmarking purposes, even if we assume away all incentive effects of the merger. Indeed, this effect has been recognized both by the Commission and by others. For instance, the Commission has noted, “[m]ergers between incumbent LECs will likely reduce experimentation and diversity of viewpoints in the process of opening markets to competition.”⁸⁷

⁸⁶ Joint Opposition, p. 99.

⁸⁷ FCC 97-286, ¶ 152.

10. Incentive Effects on Benchmarking Due to a Merger

110. A merger between firms with market power that compete in a product market has anticompetitive incentive effects that are well understood by competition authorities.⁸⁸ The “unilateral” effects stem from each merging party’s incentive to help its new partner.

111. When two firms compete in a product market, each has opportunities to engage in behaviors that (a) are socially desirable, (b) are profitable for that firm, (c) reduce the profits of the other firm, and (d) therefore are less likely to take place after a merger between the firms. In the case of product-market competition, “lowering price towards marginal cost” is the paradigmatic example of such competitive behavior, although quality improvements, innovation, and other effects are also (and in some cases more) important. For this reason, antitrust authorities will challenge a merger between such firms if consumers lack adequate other alternatives, and if the change in incentives is likely to lead to significant worsening of the firms’ offers to consumers.

112. When two ILECs are subject to benchmark regulation, similar economic forces are at work. The socially desirable behavior that the merged firm could undertake includes lowering access costs and accommodating the entry of CLECs. Although an individual ILEC may sometimes be willing to take such actions, those actions may harm other ILECs – by raising the average level of performance against which they are judged, by raising best practice performance, or by increasing the disparities

⁸⁸ U. S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (revised April 8, 1997).

among the performances of various firms. Although each ILEC will generally ignore the effects of its own behavior on other ILECs, after a merger, each merger partner will take into account the effects of its behavior on the standards that will be applied to the partner. Thus, in addition to the increased incentive of the merger partners to discriminate against CLECs because of their larger footprint, each partner also has an incentive to reduce its level of cooperation with CLECs in order not to have the same level of performance imposed on its new partner. These latter incentives worsen the comparative information available and impair average-practice, best-practice, and other forms of benchmarking.

10.1. *Unilateral Incentive Effects of Merger under Average-Practice Benchmarking*

113. Average-practice benchmarking sets firms into a form of competition with one another even if they do not compete in any conventional product market. As Vickers has expressed it, if two agents face a similar incentive scheme in which each agent's rewards are based both on its own and another's performance, the agents "are in competition in the sense that the reward of each partly depends on performance relative to that of the other agent."⁸⁹ The establishment of benchmarks thus creates "competition-by-comparison" between firms that do not directly compete with each other in the same geographic markets.

114. As one might expect from this observation, mergers between firms whose performance is regularly compared under benchmarking can have adverse unilateral

⁸⁹ John Vickers, "Concepts of Competition," *Oxford Economic Papers*, January 1995, Vol. 47, No. 1, p. 10.

incentive effects that are very similar to the corresponding anticompetitive effects of mergers among direct product-market competitors. Thus, consider the effect of a merger on the incentive to reduce access costs. After the merger, each of the partners in the merged firm will internalize the effect of its cost reductions on its new partner's profits. Compared to the situation before the merger, when the firms were competitors-by-comparison, this reduces each firm's incentive to lower its costs.⁹⁰

115. If (say) AT&T lowers its recorded access costs, this will reduce average ILEC access costs, and will, under average performance regulation, require BellSouth, and other ILECs, to reduce their access prices. This will make BellSouth worse off. Post-merger, therefore, the incentive for the merged firm to reduce its access costs in the former AT&T's area will therefore be lower than the incentives AT&T faced prior to the merger. Symmetrically, BellSouth's incentive to lower costs also declines.

10.2. Unilateral Incentive Effects of Merger under Best-Practice Benchmarking

116. A merger will similarly weaken the effectiveness of best-practice benchmarking because of the adverse (unilateral) *incentive* effects of taking a merger partner's interests into account. In our analysis of this problem, we distinguish two cases: (a) the merged firm sets a common practice for both partners, and (b) the formerly independent (now merged) firms maintain two different practices. Although the analysis of these cases is somewhat different, the key themes and qualitative

⁹⁰ Although ILECs in different geographic areas are also suppliers of complements—each supplies originating access for calls terminating in the other's territory—this effect is surely small compared to the effects considered here.

REDACTED-FOR PUBLIC INSPECTION

result—a loss of effectiveness for best-practice benchmarking—are the same in both.

117. When the merged firm sets a common practice, that practice is likely to lie strictly between the practices that the two parties would have set separately absent the merger. As noted above, under best-practice benchmarking, only the best observation among all firms in the industry ultimately counts. Thus, either the merger makes no difference (because neither merging party would have provided that best observation), or the merger moves the firm with the best practice closer to the other partner's preferences (because the best-practice firm now internalizes the effect on its partner), which lowers the standard against which other firms are judged.

118. In some instances, the partners in the merged firm will maintain different practices. However, even in this case there is an incentive to “shade” the previously independent choice in the direction of the merger partner that is less cooperative toward CLEC entry. This is so because, after the merger, the more cooperative partner will take into account the effect of its behavior on the level of cooperation that regulators will demand of its merger partner, and will reduce its level of cooperation accordingly.

119. It is important to note that even if the merger improves the performance of the less cooperative partner, this improvement does not mitigate the impairment of the best-practice benchmark. While a merger between an ILEC that (in a particular matter) is cooperative with new competitors and one that is intransigent may moderate the behavior of both, under best-practice benchmarking it is only the

merger's effect on the cooperative ILEC that affects the final result, and that partner's level of cooperation is likely to fall. As a result, other ILECs will be judged against a less stringent standard in the future.

10.3. *Coordinated Effects and Risk of Collusion*

120. Recall from our discussion above that, under competition-by-comparison (as under product-market competition), each ILEC can undertake actions that are socially desirable and profitable but that harm the interests of other ILECs. A merger can increase the threat that a common understanding will develop (explicitly or implicitly) not to engage in such behavior. We believe that a substantial decrease in the number of relevant independent firms (and for some purposes only large ILECs may be relevant firms) can significantly increase this threat.

121. This, too, is not a novel point. Indeed, the Commission has observed that, although ILECs have a common interest in minimizing their cooperation with regulators and competitors who are seeking to open their local markets to competition, "On any particular issue ... one incumbent LEC may have an incentive to cooperate with its competitors, contrary to the interests of other LECs," an incentive that may arise from regional differences between the ILECs.⁹¹ The Commission rightly observed that if two major ILECs merge, the incentive for an individual ILEC to "break ranks" and cooperate with pro-competitive processes may be reduced.

⁹¹ FCC 97-286, ¶ 154.

REDACTED-FOR PUBLIC INSPECTION

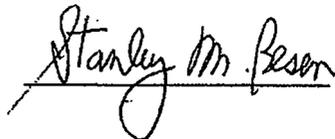
122. As in the product-market case, such parallelism is more likely the smaller the number of large ILECs. In large part, this is because of the diversity discussed above in the context of best-practice benchmarking. That is, with many ILECs, it is more likely that there will be one or two mavericks on any complex issue. With a large number of players, an ILEC contemplating aggressively cutting costs or boldly innovating will be less inclined to worry about offending the others by breaking an otherwise united front. By contrast, as the number of ILECs is reduced by merger, they become more likely to be able to coordinate their behavior and refrain from socially desirable actions.

123. Our discussion of the use of comparative and benchmark techniques by telecommunications regulators illustrates one of the important losses from mergers among large ILECs. We note again that not only regulators but also customers and suppliers of complements (such as IXCs), as well as nascent competitors, can and do compare ILECs against one another. With only four relatively large ILECs remaining after earlier mergers, the loss of one ILEC would substantially damage efficient regulation, including the regulation necessary for the growth of competition in local exchange and exchange access markets

REDACTED-FOR PUBLIC INSPECTION

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on July 19, 2006

A handwritten signature in cursive script that reads "Stanley M. Besen". The signature is written in black ink and is positioned above a horizontal line.

Stanley M. Besen

REDACTED-FOR PUBLIC INSPECTION

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on July 19, 2006

A handwritten signature in black ink, appearing to read "Bridger M. Mitchell", written over a horizontal line.

Bridger M. Mitchell